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# Causation and Reliance in Private Actions Under SEC Rule 10b-5

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## Causation and Reliance in Private Actions Under SEC Rule 10b-5

MICHAEL P. WHALEN\*

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Reliance established the necessary causal relationship between the defendant's conduct and the plaintiff's entrance into a transaction in the common law action for misrepresentation.<sup>1</sup> This requirement was incorporated directly from the common law into private actions under Rule 10b-5.<sup>2</sup> The broad scope of private actions under Rule 10b-5,<sup>3</sup> particularly in the context of omissions,<sup>4</sup> called for the development of a causal standard especially tailored for the rule. Thus, the Supreme Court in *Affiliated Ute Citizens v. United States*,<sup>5</sup> held that "under the circumstances of [that] case," "positive proof of reliance" on an omission was unnecessary, and that an "obligation to disclose and [the] withholding of a material fact establish the requisite element of causation in fact" for a private action under Rule 10b-5.<sup>6</sup> This holding is commonly referred to as the *Ute* "presumption" of reliance from materiality.

The Court's reasons for this holding are difficult to decipher from reading the opinion. Research into the background and authority cited for the case indicate that the Court's holding is dependent on the relationship between the plaintiff and defendant, in particular, the fact that the plaintiff "generally relied" on the defendant.

The Fifth and Sixth Circuits have adopted this view.<sup>7</sup> The Second Circuit,<sup>8</sup> however, interprets the *Ute* case quite differently, understanding its holding to be independent of the relationship between the parties and thus applicable to market trading. When, as in most cases,

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1. W. PROSSER, HANDBOOK OF THE LAW OF TORTS §108, at 774-75 (4th ed. 1971) [hereinafter cited as PROSSER].

2. 1 A. BROMBERG & L. LOWNEFELS, SECURITIES FRAUD & COMMODITIES FRAUD §2.7(1), at 55 (1979) [hereinafter cited as BROMBERG & LOWNEFELS]; 3 L. LOSS, SECURITIES REGULATION 1430-44 (2d ed. 1961) [hereinafter cited as LOSS].

3. 17 C.F.R. §240.10b-5 (1981). 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, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The private right of action was first recognized in *Kardon v. National Gypsum Co.*, 60 F. Supp. 512 (E.D. Pa. 1947), modified on other grounds, 83 F. Supp. 61 (1947). The Supreme Court recognized the private right of action in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

4. See text accompanying notes 75-83 *infra*.

5. 406 U.S. 128 (1972).

6. *Id.* at 153-54.

7. *Fridrich v. Bradford*, 542 F.2d 307, 318-20 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977); *Simon v. Merrill Lynch*, 482 F.2d 880, 883-84 (5th Cir. 1973).

8. *Shapiro v. Merrill Lynch*, 495 F.2d 228, 238-40 (2d Cir. 1974).

“general reliance” is present, the two interpretations of *Ute* give similar results. However, even in those cases several uncertainties exist in the application of the *Ute* decision. An examination of lower court decisions indicates that the “presumption” should be limited to cases involving only omissions or involving both omissions and misrepresentations, and that, if the presumption is applied, it should be rebuttable.<sup>9</sup>

Most courts have not reached the question of whether “general reliance” should be required or where the burden of proof on the issue should lie, since such reliance is obviously present in the usual case of personal dealings between the parties. Analysis of the *Ute* opinion indicates that the plaintiff should have the burden of proving “general reliance” before the *Ute* presumption applies.<sup>10</sup>

The Ninth Circuit has applied a *Ute* type presumption in the “fraud on the market” situation<sup>11</sup> to imply causation from materiality. This presumption is itself defensible in that context, but the Court also creates an expansion in the definition of causation in the market context. This expansion is unfortunate because the proper focus for the decision should not have been causation at all, but policy, a position also advocated for the open market situation.

An examination of the dispute between the two interpretations of *Ute* as applied to the open market leads to the conclusion that the Sixth Circuit was correct in its application of *Ute*, but incorrect as a matter of policy.<sup>12</sup> The idea of causation on a non-event, such as an omission, is so tenuous that policy should be examined directly in determining liability. Such an approach has been adopted by the American Law Institute in the Federal Securities Code.<sup>13</sup>

The Code eliminates the causation requirement in civil suits for liability in several common Rule 10b-5 situations, including the open market situation and in cases where there is privity between the plaintiff and defendant.<sup>14</sup> Limitations on damages and a deterrent intent justify this change in the law. In addition, the theories developed in *Affiliated Ute* indicate the appropriateness of the elimination of the causal requirement where the Code has done so.

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9. See text accompanying notes 204-218 *infra*.

10. See text accompanying notes 219-221 *infra*.

11. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975).

12. See text accompanying notes 228-235 *infra*.

13. *See* FED. SEC. CODE §1703(a), (b) (Proposed Official Draft 1978).

14. See notes 236-242 and accompanying text *infra*.

I. THE ORIGINS OF RELIANCE AND CAUSATION  
IN THE COMMON LAW

The development of reliance and causation under Rule 10b-5 cannot be examined without a basic understanding of their role in the rule's predecessor, the common law action for misrepresentation.<sup>15</sup> To recover under this action a plaintiff must show:

- 1) a false representation
- 2) of material fact,
- 3) scienter on the defendant's part including an intent to induce
- 4) and the inducement of plaintiff's justifiable reliance, and
- 5) resulting damages.<sup>16</sup>

The first requirement for the action is a misrepresentation. Nondisclosures are not generally actionable at common law.<sup>17</sup> However, in two types of situations the law does imply a duty to disclose facts.<sup>18</sup> The first situation is one in which there is an expectation of disclosure from the relationship between the parties. The disappointment of this expectation gives rise to civil liability for fraud where there is a fiduciary or special confidential relationship between the parties. There is also liability when the defendant is aware of facts "basic" to the transaction, as to which he knows plaintiff is acting under a misapprehension, when plaintiff could reasonably expect a disclosure due to the "customs of the trade."<sup>19</sup> The other situation in which an obligation to disclose is imposed involves misleading statements and misrepresentations. When the defendant makes a statement, he must disclose enough information so that it is not misleading.<sup>20</sup> Anyone who has made a statement which he discovers to be misleading must disclose such information to anyone whom he knows to be still relying on it.<sup>21</sup> Finally, if a misrepresentation is not made with the expectation that it would be

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15. See note 2 *supra*.

16. RESTATEMENT (SECOND) OF TORTS §§525 (general liability for fraudulent misrepresentation), 526 (scienter), 531 (expectation of influencing conduct), 537 (justifiable reliance), 538 (materiality) (1977) [hereinafter cited as RESTATEMENT]; 1 F. HARPER & F. JAMES, THE LAW OF TORTS §7.1, at 527-72 (1956) [hereinafter cited as HARPER & JAMES], PROSSER, *supra* note 1, §105, at 685-86.

17. HARPER & JAMES, *supra* note 16, §7.14, at 586; PROSSER, *supra* note 1, §106, at 695-96. This rule of course reflected the dubious business ethics of the bargaining transactions with which deceit was at first concerned, together with a touch of the old tort notion that there can be no liability for nonfeasance, or merely doing nothing (footnote omitted). PROSSER, *supra* note 1, §106, at 696. The terms "nondisclosure" and "omission" are used interchangeably in this paper.

18. RESTATEMENT, *supra* note 16, §551; HARPER & JAMES, *supra* note 16, §7.14, at 586; PROSSER, *supra* note 1, §106, at 696.

19. RESTATEMENT, *supra* note 16, §551(2)(a)(e); HARPER & JAMES, *supra* note 16, §7.14, at 589; PROSSER, *supra* note 1, §106, at 697-98.

20. RESTATEMENT, *supra* note 16, §551(2)(b); HARPER & JAMES, *supra* note 16, §7.14, at 586-87; PROSSER, *supra* note 1, §106, at 696.

21. RESTATEMENT, *supra* note 16, §551(2)(c); HARPER & JAMES, *supra* note 16, §7.14, at 589; PROSSER, *supra* note 1, §106, at 696-97.

acted upon, but the defendant later learns the plaintiff is about to act in reliance upon it in a transaction between them, the defendant must disclose its falsity.<sup>22</sup>

In addition, the defendant is liable for his nondisclosure if he conceals or prevents the plaintiff from discovering material information.<sup>23</sup> In these situations, the defendant is liable as if he had stated the nonexistence of the undisclosed facts.<sup>24</sup> In fact, in most<sup>25</sup> of these situations defendant's conduct is very similar to an actual statement that these facts were untrue. These situations are essentially ones of "action," not "inaction." That is, none of these situations involves a "pure nondisclosure."<sup>26</sup> Thus, it is not surprising that the causal standard developed for those cases and for misrepresentations proved to be inadequate for nondisclosures in the context of Rule 10b-5.<sup>27</sup>

Scienter, the element of intent required for the tort of misrepresentation "involves the intent that a representation shall be made, that it shall be directed to a particular person or class of persons, that it shall convey a certain meaning, that it shall be believed, and that it shall be acted on in a certain way."<sup>28</sup> The defendant must believe the matter is not as he represents it to be or that he does not have the basis for his representation or the confidence in its accuracy that he states or implies.<sup>29</sup> Mere negligence in holding the mistaken belief is not sufficient

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22. RESTATEMENT, *supra* note 16, at §551(2)(d); HARPER & JAMES, *supra* note 16, §7.14, at 589.

23. RESTATEMENT, *supra* note 16, §550.

24. RESTATEMENT, *supra* note 16, §§550, 551.

25. The exceptions are the fiduciary situation, the case of concealment and the case in which the customs of the trade induce plaintiff's expectation of disclosure. The fiduciary case is really one of breach of a fiduciary duty, not common law fraud. The concealment case is also not a real nondisclosure case. The final case is essentially a sort of half-truth. Since the defendant knows the plaintiff expects disclosure, his actions are really a misleading "statement" that the nondisclosed facts are untrue.

26. That is, except for the fiduciary duty case which is explained in note 25 *supra*.

27. The causal standard is that of reliance, i.e., the plaintiff must show that he believed the omitted facts were not true. RESTATEMENT, *supra* note 16, §§546, 551 (defendant's nondisclosure is treated as if he had represented that the omitted facts were true). This is reasonable since the actionable nondisclosures are essentially half-truths, see note 25 *supra*, which give a basis for formation of this belief. See text accompanying notes 206-207 *infra*. For the application to Rule 10b-5 see text accompanying notes 110-114 *infra*.

28. PROSSER, *supra* note 1, §17, at 700. The Restatement does not require an "intent to induce reliance" in defining scienter. Instead it restates the requirement as a limitation on the class of plaintiffs who can recover from the defendant's misrepresentation. RESTATEMENT, *supra* note 16, §§526 (scienter), 531 (expectation of influencing conduct).

There is no requirement that the defendant intend to harm the plaintiff. As Lord Blackburn said:

The defendant might honestly believe that the shares of stock were capital investment, and that they were doing the plaintiff a kindness by tricking him into buying them. I do not say this is proved, but if it were . . . they are civilly responsible for a deceit.

Smith v. Chadwick, 9 App. Cas. 1-7, 201 (1884) cited in HARPER & JAMES, *supra* note 16, §7.3, at 532-33. "The law affords . . . protection against such 'favors' . . . and it is no defense in an action for deceit that the defendant was a well meaning, though unscrupulously zealous, 'friend'."

29. RESTATEMENT, *supra* note 16, §526; PROSSER, *supra* note 1, §107, at 701.

to support an action for misrepresentation.<sup>30</sup>

This strict standard of intent affects the causal connection required for the tort. In essence, there is no need for a proximate cause analysis in intentional torts.<sup>31</sup> However, the relaxation of the scienter requirement and the coverage of nondisclosures in the private action under Rule 10b-5, greatly increase the need in those actions for such an analysis. Thus duty, in a concept normally not present in common law fraud actions, is an element in private actions under Rule 10b-5 for nondisclosures. These concepts will be developed in more detail below.<sup>32</sup>

### A. The Causal Requirement—Reliance

As in all common law torts, the plaintiff must show a causal connection between the defendant's conduct and the plaintiff's harm to prevail in a misrepresentation action.<sup>33</sup> Plaintiff meets this requirement by showing that he was injured by his reliance on the defendant's misrepresentation.<sup>34</sup> This proof must satisfy the requirements of causation in law as well as causation in fact.<sup>35</sup> In addition, two related requirements, materiality of the misrepresentation and "justifiability of belief" must be satisfied.<sup>36</sup>

#### 1. Causation in Law and Causation in Fact

The causation requirement is generally satisfied in tort law by showing that the defendant's conduct was the "legal cause" or the "cause in law" of the plaintiff's harm.<sup>37</sup> For conduct to be a "legal cause" of an event it must first, be a "cause in fact" of the event and then, be such that the law on policy grounds should recognize it as a cause.<sup>38</sup> Causation

30. PROSSER, *supra* note 1, §107, at 701; "[H]onest belief in the truth [is] a complete defense, under all circumstances, but anything short of such an actual and honest belief, on the part of the defendant, will constitute fraud." HARPER & JAMES, *supra* note 16, §7.3, at 534.

31. HARPER & JAMES, *supra* note 16, §7.13, at 584.

32. See text accompanying notes 128-129 *infra*.

33. RESTATEMENT, *supra* note 16, §§546 (causation in fact), 548A (legal causation of pecuniary loss); HARPER & JAMES, *supra* note 16, §7.13, at 583; PROSSER, *supra* note 1, §108, at 714.

34. RESTATEMENT, *supra* note 16, §§546, 548A; HARPER & JAMES, *supra* note 16, §7.13, at 583; PROSSER, *supra* note 1, §108, at 714.

35. RESTATEMENT, *supra* note 16, §§546, 548A.

36. RESTATEMENT, *supra* note 16, §§537, 538; PROSSER, *supra* note 1, §108, at 715-20.

37. HARPER & JAMES, *supra* note 16, §7.13, at 583; PROSSER, *supra* note 1, §42, at 244.

38. The actor's conduct is a legal cause of harm to another if

- a) his conduct is a substantial factor in bringing about the harm, [a cause in fact] and
- b) there is no rule of law relieving the actor from liability because of the manner in which his [conduct] has resulted in the harm.

RESTATEMENT, *supra* note 16, §431 (negligence).

As a practical matter, legal responsibility must be limited to those causes [in fact] which are so closely connected with the result and of such significance that the law is justified in imposing liability.

PROSSER, *supra* note 1, §41, at 236-37.



tion in fact is established by showing that the harm would not have occurred "but for" the defendant's conduct.<sup>39</sup> Alternatively, "the defendant's conduct is a cause [in fact] of the event if it was a material element and a substantial factor in bringing it about."<sup>40</sup>

To be a legal cause, conduct which is a cause in fact of harm must also be of such a nature that policy requires the defendant's liability.<sup>41</sup> This is not a question of causation at all, but one of policy.<sup>42</sup> Thus, there is the doctrine of "proximate cause," which, essentially, frames the question in terms "of whether the defendant is under any duty to the plaintiff, or whether his duty includes protection against such consequences."<sup>43</sup> Thus, if the plaintiff's harm was outside of the "zone of obvious danger from the defendant's conduct [as defined by tort policy], and so no harm to him was to have been anticipated," the conduct is not a legal cause of the harm.<sup>44</sup> This "zone of danger" can be thought of as the zone of reasonably foreseeable events.<sup>45</sup> If the event is an unforeseeable result of the conduct (that is, "unlikely" in some sense), then the conduct is not a legal cause of the harm.

This "legal cause" analysis is equivalent to that of "duty" in the sense of common law torts.<sup>46</sup> That is, once causation in fact is established, the "proximate" cause question can be rephrased as "under the relevant public policy should the court determine that the defendant had a duty to the plaintiff such that he is liable for the harm he caused?"<sup>47</sup>

In misrepresentation actions, just as in other tort actions, there has been some confusion between the concepts of causation in law and causation in fact. This confusion persists even in the analysis of causation under Rule 10b-5.<sup>48</sup> It is, however, very important to distinguish between the two concepts in order to analyze causation correctly.

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39. PROSSER, *supra* note 1, §41, at 238-39. Causation in fact also includes the case where the defendant's conduct along with one or more other causes would each have been enough to produce the harm by itself, but which is not a "but for" cause because of the existence of the other causes. PROSSER, *supra* note 1, §41, at 240.

40. *Anderson v. Minneapolis, St. Paul & S.S. M.R. Co.*, 146 Minn. 430, 179 N.W. 45 (1970) cited in PROSSER, *supra* note 1, §41, at 240. The Restatement defines causation in fact in the negligence situation as "a substantial factor in bringing about the harm." RESTATEMENT, *supra* note 16, §431, which is present only if the harm would not have been sustained in its absence, RESTATEMENT, *supra* note 16, §432.

41. RESTATEMENT, *supra* note 16, §431; PROSSER, *supra* note 1, §42, at 244.

42. RESTATEMENT, *supra* note 16, §431(b); PROSSER, *supra* note 1, §42, at 244.

43. PROSSER, *supra* note 1, §42, at 244.

44. PROSSER, *supra* note 1, §42, at 245.

45. RESTATEMENT, *supra* note 16, §435; PROSSER, *supra* note 1, §42, at 250.

46. PROSSER, *supra* note 1, §42, at 244-45.

47. See PROSSER, *supra* note 1, §42, at 244-45.

48. See text accompanying notes 175-176 *infra*.

## 2. Loss Causation and Transaction Causation

The plaintiff in a misrepresentation action satisfies the causation requirement by a showing that the defendant's conduct caused his economic harm. He does this by proving that he relied on the misrepresentation and was injured by that reliance.<sup>49</sup> To prove reliance plaintiff shows that he believed the misrepresentation and that belief was a cause of his entrance<sup>50</sup> into the transaction.<sup>51</sup> Proof of damages resulting from that reliance is easy as a matter of causation in fact but must also meet the standard of proximate cause or causation in law.<sup>52</sup>

A slightly different analysis of this causation requirement is useful in the Rule 10b-5 setting. To facilitate the later use of this analytical structure, it is now introduced in the common law context. To show the requisite causal connection in the case of a misrepresentation under Rule 10b-5, the plaintiff must prove "transaction causation" and "loss causation."<sup>53</sup>

Plaintiff proves transaction causation by showing that defendant's conduct caused him to enter into the transaction. Loss causation is shown by proof that his entrance into the transaction caused plaintiff's claimed loss. Proof of both transaction and loss causation establishes the requisite causal connection for the tort.

From the discussion of causation in fact and causation in law above, it may be expected that both types of causation must be shown in each of these causal links between the defendant's conduct and the plaintiff's harm. This is true theoretically, and may have some importance in the context of Rule 10b-5,<sup>54</sup> but in the common law misrepresentation action, the analysis is not so complicated. The transaction causation link only requires a causation in fact analysis; the loss causation link is shown through legal cause. Transaction causation in this setting re-

49. PROSSER, *supra* note 1, §108, at 714-20.

50. Reliance can result in plaintiff refraining from entering into a transaction. This is also actionable at common law. PROSSER, *supra* note 1, §108, at 714-20. See note 107 *infra*. For simplicity, reference throughout this paper is made only to the positive effect.

51. PROSSER, *supra* note 1, §108, at 714-20.

52. "A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance." RESTATEMENT, *supra* note 16, §58A (Legal Causation of Pecuniary Loss).

The recipient of a fraudulent misrepresentation is entitled to recover as damages in an action of deceit against the maker the pecuniary loss to him of which the misrepresentation is a legal cause, including (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and (b) pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation.

RESTATEMENT, *supra* note 16, §549(1).

53. See note 95 *infra*.

54. See text accompanying notes 128-129 *infra*.

quires no legal cause analysis because there is no need for policy limitations on causation in fact in this causal link. That is, if defendant's conduct causes plaintiff to enter into a transaction, there is no need to limit defendant's liability for resulting damages through, for example, plaintiff's unexpected reliance. No such limitation is necessary because misrepresentation is an intentional tort.<sup>55</sup> Given scienter, with its element of an intent to induce reliance, there is no need for policy limits on the defendant's liability for damages resulting from that reliance.

Thus, transaction causation in the common law involves only a causation in fact analysis. Plaintiff proves transaction causation by showing that the defendant's misrepresentation caused him to enter into the transaction. This, in turn, is shown by proof of plaintiff's reliance, that is, plaintiff believed the misrepresentation and this belief caused him to enter into the transaction. Transaction causation, then, is just reliance in the common law setting, a causation in fact analysis.<sup>56</sup>

Causation in the loss causation link involves both causation in fact and legal cause. Causation in fact is merely a requirement that plaintiff's entrance into the transaction caused his loss. This is normally obvious in the common law setting. The real thrust of loss causation is whether the defendant as a policy matter should be liable for the damages resulting from the plaintiff's transaction. For example, the defendant is not liable for completely unforeseeable consequences of the reliance.<sup>57</sup> Thus, loss causation in the common law is essentially a question of legal cause.

Under either analysis, an important aspect of the causation requirement in the common law is obvious: the standard is constructed for misrepresentations. Transaction causation, reliance, is based on belief in the misrepresentation. Extension of this concept to nondisclosures<sup>58</sup>

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55. RESTATEMENT, *supra* note 16, §435A; HARPER & JAMES, *supra* note 16, §7.13 at 584.

56. A mild form of legal cause does apply to transaction causation in the common law. Originally courts restricted the class of possible claimants by use of the scienter doctrine, which certainly constituted a strict form of legal cause. This proving too strict however, they changed to a more moderate form of legal cause, holding that there was sufficient scienter if there was scienter vis-à-vis another person and the present plaintiff's reliance was reasonably foreseeable. PROSSER, *supra* note 1, §107, at 702-04. The Restatement also applies a minor "legal cause" analysis to transaction causation.

One who makes a fraudulent misrepresentation is subject to liability to the persons . . . whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation for pecuniary loss suffered by them through their justifiable reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced.

RESTATEMENT, *supra* note 16, §531. The Reporters add a caveat to section 531:

The Institute expresses no opinion on whether the liability . . . may extend beyond [this] rule . . . to other persons or other types of transactions, if reliance upon the representation in acting or in refraining from action may be reasonably foreseen.

57. See note 52 *supra*.

58. See text accompanying notes 118-127 *infra*.

in the context of Rule 10b-5 will prove to be a difficult matter.

### 3. Justifiable Reliance—Unbelievability and Materiality

Even if the defendant's misrepresentation might be shown to be the cause of the plaintiff's harm, the common law excuses the defendant from liability if he can show that the plaintiff's reliance was not "justified."<sup>59</sup> The defendant can prove this in two ways. He can show that the misrepresentation was so unbelievable that the plaintiff had no business relying on it.<sup>60</sup> Alternatively, the defendant can show that the misrepresentation was of a matter so trivial (immaterial) that the plaintiff's reliance was "unjustified."<sup>61</sup>

The standard for the justifiability of the plaintiff's belief in the misrepresentation is not high. "The plaintiff's conduct must not be so utterly unreasonable, in the light of the information open to him, that the law may properly determine that his loss is his own responsibility."<sup>62</sup> The justification for this requirement seems to be the practical difficulties of proof in these situations and the "corresponding opportunity for fraud and injustice."<sup>63</sup> The apparent unfairness of this result may be required by the difficulty of administering the system. "Moreover, there is the attitude, . . . that a person may be so great a fool that the law cannot protect him even from a knave."<sup>64</sup>

Indeed the cases barring recovery under this standard are those in which the plaintiff put his faith in misrepresentations that "any such normal person would recognize . . . as preposterous, . . . or which are . . . so patently and obviously false that [the plaintiff] must have closed his eyes to avoid discovery of the truth . . . ." <sup>65</sup> Thus, this is a minor limitation on causation. The plaintiff need only exercise a minimal amount of care in entering the transaction.<sup>66</sup>

59. RESTATEMENT, *supra* note 16, §537; PROSSER, *supra* note 1, §108, at 715-20.

60. RESTATEMENT, *supra* note 16, §541 (representation known to be or obviously false); PROSSER, *supra* note 1, §108, at 715-18.

61. RESTATEMENT, *supra* note 16, §538 (materiality); HARPER & JAMES, *supra* note 16, §7.9, at 565-70; PROSSER, *supra* note 1, §108, at 718-20.

62. PROSSER, *supra* note 1, §108, at 715. This standard is not strict.

[T]he person deceived is not held to the standard of precaution, or of minimum knowledge, or of intelligent judgment, of the hypothetical reasonable man, that people who are exceptionally gullible, superstitious, ignorant, stupid, dim-witted, or illiterate, have been allowed to recover when the defendant knew it, and deliberately took advantage of it.

PROSSER, *supra* note 1, §108, at 717.

63. Harper & McNeely, *A Synthesis of the Law of Misrepresentation*, 22 MINN. L. REV. 939, 943 (1938) [hereinafter cited as Harper & McNeely].

64. Harper & McNeely, *supra* note 63, at 944.

This rule may contain low ethical implications, but it most certainly conforms with common sense. Therefore, it may be said to conform to the law and popular morality, although it may not conform either to ideal justice or to ethics.

Harper & McNeely, *supra* note 63, at 943.

65. PROSSER, *supra* note 1, §108, at 716.

66. RESTATEMENT, *supra* note 16, §541.

Even though the plaintiff is justified in believing a misrepresentation, it might be so unimportant that he is not legally justified in entering into a transaction based on that belief.<sup>67</sup> Without this legal limitation, it would be

exceedingly dangerous for parties to conduct the ordinary business transactions of the day. It frequently happens that representations are made, while negotiations are pending, not strictly true. They may relate to the subject matter, or have little or no reference thereto. Neither party may place the slightest reliance thereon, yet, should a dispute thereafter arise, how easy for the person who imagined he was injured to assert he relied upon the representations made—believed them to be true—and, so believing, was thereby induced to make the contract in dispute.<sup>68</sup>

In short, the plaintiff should not be able to use any “misrepresentation as a pretext for escaping a bargain he is dissatisfied with on other grounds.”<sup>69</sup> Thus, an objective standard of “importance,” materiality,<sup>70</sup> has been developed. A misrepresentation is “material” if a reasonable man would be expected to attach importance to it in determining his choice of action.<sup>71</sup> A misrepresentation is also material if it is intended to deceive and the maker knows that the recipient is “peculiarly disposed to regard it as important, even though the standard reasonable man would not do so.”<sup>72</sup>

Materiality is very close to reliance itself. If a material fact is misrepresented then, “a reasonable man would be expected to attach importance to it in making his choice of action,” which is almost the same as saying that a reasonable man would rely on it, if he believed it. Thus, given materiality and justifiable belief (a minor requirement) the plaintiff really only needs to show that he is a reasonable man to establish reliance.<sup>73</sup> This close relationship between materiality and reliance plays an important role in the development of the causal connection

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67. RESTATEMENT, *supra* note 16, §§537, 538, 540; PROSSER, *supra* note 1, §108.

68. *Hall v. Johnson*, 41 Mich. 286, 289-90, 2 N.W. 55 (1876), *quoted in* HARPER & JAMES, *supra* note 16, §7.9, at 567.

69. PROSSER, *supra* note 1, §108, at 719, (quoting Keeton, *Actionable Misrepresentation*, 2 OKLA. L. REV. 56, 59 (1949)).

70. See note 67 *supra*.

71. RESTATEMENT, *supra* note 16, §538, at 2; HARPER & JAMES, *supra* note 16, §7.9, at 565-66; PROSSER, *supra* note 1, §108, at 719.

[M]atters entirely collateral to a contract, and apparently of no significance to any reasonable man under the circumstances have been held to be immaterial: the defendant's social, political and religious associations, his motive or purpose in entering the bargain, the details of a seller's title, where good title is still conveyed, . . . and many other items of similar nature (footnote omitted).

PROSSER, *supra* note 1, §108, at 719.

72. PROSSER, *supra* note 1, §108, at 720. See RESTATEMENT, *supra* note 16, §538, at comment f.

73. See text accompanying notes 139-142 *infra*.

required for private actions under Rule 10b-5.<sup>74</sup>

## II. RELIANCE AND CAUSATION UNDER RULE 10b-5

Rule 10b-5<sup>75</sup> was promulgated by the Securities and Exchange Commission in 1942<sup>76</sup> under section 10(b) of the Securities Exchange Act of 1934.<sup>77</sup> There is now a widely recognized private action under the rule to recover damages for securities fraud.<sup>78</sup> Though the action is based on the common law action for misrepresentation,<sup>79</sup> its scope is much broader.<sup>80</sup> In particular, the rule explicitly forbids nondisclosures of material facts, though only in the context of actual statements.<sup>81</sup> The courts, however, have construed "scheme to defraud" in clauses (a) and (c) of the rule to include the case of complete silence when there is a duty to speak.<sup>82</sup>

The scienter requirement (including "intent to induce reliance") is much less stringent in Rule 10b-5 actions.<sup>83</sup> These changes in the elements of the common law action for misrepresentation have resulted in changes in the nature of the required causal connection.

### A. *Scienter and Materiality*

Until 1976 there was a controversy whether scienter should be required to prove a case for Rule 10b-5.<sup>84</sup> In that year the Supreme Court held in *Ernst & Ernst v. Hochfelder*<sup>85</sup> that scienter is required. However, the actual holding of *Hochfelder* was quite narrow. The court merely held that negligence was not enough to prove an action for Rule 10b-5. Thus, though the exact requirement is not well defined at this time, the intent to be proven for Rule 10b-5 is not nearly as stringent as for common law fraud. Fraud covered under Rule 10b-5 for most of its history was not an *intentional* tort. It probably still is not.<sup>86</sup> In addition, there seems to be no requirement at all in the action

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74. See text accompanying notes 139-144 *infra*.

75. See note 3 *supra*.

76. Securities Act Release No. 3230 (May 21, 1942); see generally BROMBERG, *supra* note 2, §2.2, at 2:18 (background of the rule).

77. 15 U.S.C. §78j(b) (1976).

78. See note 3 *supra*.

79. See note 2 *supra*.

80. BROMBERG & LOWNEFELS, *supra* note 2, §2.7(1), at 55; LOSS, *supra* note 2, at 1435-36. See *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963). *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

81. 17 C.F.R. §240.10b-5 (1981).

82. *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962); BROMBERG & LOWNEFELS, *supra* note 2, §2.6(2), at 51; LOSS, *supra* note 2, at 1439; see *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951).

83. See text accompanying notes 85-92 *infra*.

84. BROMBERG & LOWNEFELS, *supra* note 2, §8.4(501), at 204.101.

85. 425 U.S. 185 (1976).

86. See BROMBERG & LOWNEFELS, *supra* note 2, at §8.4(50).

that the defendant intended to induce plaintiff's reliance.<sup>87</sup>

The change from an intentional tort in the common law to a somewhat less intentional tort under Rule 10b-5 has had an effect on the nature of the transaction causation required to be proved. In particular, "duty" is now an element to be proven in cases of nondisclosures.<sup>88</sup> This "legal cause" requirement stems partially from the relaxed scienter standard. It is discussed in more detail below.<sup>89</sup>

The materiality requirement for private actions under Rule 10b-5 is the same as for common law fraud, "would a reasonable man find the fact important in making the decision whether to enter into the transaction or not?"<sup>90</sup> Because of its similarity to reliance,<sup>91</sup> materiality plays a major role in cases of nondisclosure. In fact, materiality has almost replaced reliance as the test of causation after the Supreme Court's decision in *Affiliated Ute*.<sup>92</sup>

### B. Reliance, Materiality and Causation

The private action under Rule 10b-5, like the common law fraud action, is compensatory in nature. Thus, in order to recover damages the plaintiff must do more than show that the defendant violated the rule; he must show that the defendant "caused" the loss complained of.<sup>93</sup>

Under the framework developed above<sup>94</sup> the causal requirement under Rule 10b-5 can be thought of as two separate issues: first, transaction causation, the defendant's conduct must cause the plaintiff to enter into the securities transaction, and second, loss causation, the plaintiff's entering into the securities transaction must cause the claimed economic loss.<sup>95</sup>

This article is concerned only with *transaction causation*.<sup>96</sup> Except in

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87. BROMBERG & LOWNEFELS, *supra* note 2, at §8.4(501).

88. See text accompanying notes 128-130 *infra*.

89. See text accompanying notes 128-130 *infra*.

90. TSC Industries Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976).

91. See text accompanying notes 139-142 *infra*.

92. 406 U.S. 128 (1972).

93. The purpose of the rule "is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investor's insurance." *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965), *cert. denied sub nom.*, *List v. Lerner*, 382 U.S. 811 (1965); 6 Loss, *supra* note 2, at 3876-80.

94. See text accompanying notes 49-58 *supra*.

95. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-82 (2d Cir. 1974); Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 123-24 (1970). This terminology is not now generally in use by courts, see Justice Frankel's concurrence in *Schlick*, 507 F.2d at 384, but it is useful here to distinguish between the two causal links implicit in a fraud "causing" a loss.

96. Loss causation in Rule 10b-5 is the same as in the common law, a legal cause analysis of damage resulting (in the sense of causation in fact) from plaintiff's reliance. See, e.g., *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 49 (2d Cir. 1978); *Feit v. Leasco Data Processing*

a few unusual cases,<sup>97</sup> the requirement of transaction causation (henceforth shortened to "causation") is the same as that of reliance, i.e., the plaintiff believed what the defendant misrepresented and this belief caused him to enter into the transaction. Thus, in most cases, reliance is the equivalent of causation. For this reason, most courts<sup>98</sup> required reliance to be proved until the Supreme Court decided *Mills v. Electric Auto Lite Co.*<sup>99</sup> and *Affiliated Ute Citizens v. United States*,<sup>100</sup> cases which hold that, in certain circumstances, causation can be established by proof of materiality.

### 1. The Non-Reliance Cases

It is, of course, possible for a misrepresentation to cause a plaintiff to enter into a securities transaction without the plaintiff believing the misrepresentation and acting on that belief. In such a case transaction causation in fact can be proven without a showing of reliance. In *Vine v. Beneficial Finance Co.*,<sup>101</sup> the defendant corporation made misrepresentations to a group of its fellow shareholders in a company, for the purpose of buying their stock. According to the plaintiff's allegations, enough of these shareholders sold, in reliance on the misrepresentations, for the defendant to gain sufficient control of the target corporation to force a short form merger. The plaintiff, who had had no misrepresentations made to him, was thus forced to give up<sup>102</sup> his shares. Clearly plaintiff did not rely on the representations. However, he was forced to sell his stock because of the misrepresentations. Therefore, there was transaction causation. The Second Circuit held that the plaintiff was a "seller," that is, that he entered into a transaction.<sup>103</sup> It continued, "[Reliance is] unnecessary in the limited instance when no volitional act is required . . . . What must be shown is that there was deception which misled [the other] stockholders and that this was in fact the cause of plaintiff's claimed injury."<sup>104</sup> Thus, the court recognized in this situation that, given proof of transactional causation in fact, reliance is not necessary.<sup>105</sup>

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Equip. Corp., 332 F. Supp. 544, 586-88 (E.D.N.Y. 1971); discussion in FED. SEC. CODE §202(19), comment 5(b), at 61 (Proposed Official Draft 1978).

97. See, e.g., *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981); *Crane v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir.), cert. denied, 400 U.S. 822 (1970); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1969).

98. 6 Loss, *supra* note 2, at 3876-78.

99. 396 U.S. 375 (1970).

100. 406 U.S. 128 (1972).

101. 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

102. Plaintiff did have a choice of using his statutory appraisal rights. *Id.* at 635.

103. *Id.*

104. *Id.*

105. The Court did not, however, use the words "transaction causation."



In *Crane Co. v. Westinghouse Air Brake Co.*,<sup>106</sup> the defendant corporation thwarted a tender offer by the plaintiff corporation by bidding up the price of the target's stock on the last day of the offer by buying it on the market and selling it privately at a loss. This conduct was not disclosed to the target's shareholders, who, thinking the value of their stock had increased, refused to tender. Thus, the tender offeror, without relying on the nondisclosure, was prevented from buying the outstanding shares by the nondisclosures. In this case, there was transaction causation, the nondisclosures prevented<sup>107</sup> the tender offeror from completing the transaction, without reliance. The Second Circuit, citing *Vine*, again held that since there was causation in fact, reliance was unnecessary to establish Rule 10b-5 liability.

The Second Circuit in these cases correctly extended the scope of the causation connection required for fraud. The court recognized that the compensatory nature of the fraud action requires only that transaction causation, not reliance, be proven. Reliance is merely the most normal form in which transactional causation appears.

These two cases stand for nothing more than the proposition that in a 10b-5 action, it is sufficient that the plaintiff show transactional causation in fact if no reliance could have occurred. The scope of these cases is limited. The type of case to which they apply, where reliance is not the causal connection between the defendant's conduct and the plaintiff's transaction is rare. Oddly enough, however, they are cited as support for a change in the reliance requirement in an important case in which reliance is the causal connection, *Chasins v. Smith, Barney & Co., Inc.*<sup>108</sup> This case will begin the study of the role of causation in the normal Rule 10b-5 omission case.

## 2. *The Background of Affiliated Ute*

The proper foundation has now been laid for an analysis of the background and present role of the Supreme Court's landmark decision in *Affiliated Ute*. That case, like most of the remaining cases to be examined, involves nondisclosures rather than misrepresentations. In *Affiliated Ute* the Court decided that, under the circumstances of that

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106. 419 F.2d 787 (2d Cir.), cert. denied, 400 U.S. 822 (1970).

107. Transaction causation can occur by the fraudulent prevention of, as well as by the causation of, the plaintiff's entrance into a transaction. This has long been the rule in common law of misrepresentation. *Butler v. Watkins*, 80 U.S. (13 Wall.) 456 (1871). See note 50 *supra*. However, the Supreme Court has limited the private right of action under Rule 10b-5 to buyers and sellers. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1974). The Federal Securities Code has, however, preserved the *Crane* holding in Section 1719(e). See Fed. Sec. Code §1710(c), comment (Proposed Official Draft 1978) on the effect of *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1967) on *Crane*.

108. 438 F.2d 1167 (2d Cir. 1970).

case, an obligation on the defendant's part to disclose accompanied by a nondisclosure of material information "establish" causation in fact.<sup>109</sup>

Examination of the background of this case and close scrutiny of its reasoning aids in understanding what exactly the Supreme Court's language in *Affiliated Ute* means and gives a guide for criticism of its interpretation in the lower courts.

#### a. *Reliance and Omissions*

The extension of common law fraud to nondisclosures under Rule 10b-5 necessarily created the problem of what causal connection between the plaintiff's actions and the defendant's nondisclosure should be required to establish liability.<sup>110</sup> In the limited action for nondisclosure under the common law this problem did not arise. What actionable nondisclosures there were, with the exception of the case of a fiduciary relationship,<sup>111</sup> all were of the sort in which there was either a misleading statement or a misrepresentation.<sup>112</sup> Reliance on the misrepresentations could be shown as in the normal case. In the case of the misleading statement, the defendant was treated as if he had stated that the facts which he knew were necessary to make his statements not misleading, were not true.<sup>113</sup> The plaintiff had to show that he believed these facts were false to show reliance.<sup>114</sup> This seemingly hard burden was lessened considerably because the plaintiff could merely point to the misleading statement and claim that, believing it, he naturally believed that the omitted facts were false.

The only real nondisclosure actionable at the common law was one involving a fiduciary duty. That very special relationship between the parties meant that the action was not really one of common law fraud, and, as such, it will not be discussed further here.

Under Rule 10b-5 the situation is much more difficult. Nondisclosures are actionable in many more situations, including those in which there was no contact between the parties at all. This was an entirely different situation from the common law. It is not, even now, clear how to establish "reliance" or causation in the case of nondisclosures, especially where there is no contact between the parties.<sup>115</sup>

109. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972).

110. *See, e.g.*, 6 LOSS, *supra* note 2, at 3878-80.

111. RESTATEMENT, *supra* note 16, at §551(2)(a). The case in which the defendant did not disclose "facts basic to the transaction" is essentially a case of misleading conduct. *See* text accompanying notes 15-22 *supra*.

112. RESTATEMENT, *supra* note 16, at §551(2)(b)-(e).

113. RESTATEMENT, *supra* note 16, at §551(1), (2)(b).

114. RESTATEMENT, *supra* note 16, at §546.

115. *See* text accompanying notes 231-233 *infra*.

Three approaches to the problem have been used. The first was to define reliance on an omission along the lines of the common law and require its proof. The second approach, developed in *List v. Fashion Park, Inc.*,<sup>116</sup> was to abandon reliance altogether and merely show that the omission was the cause in fact of the transaction. The third was to “presume” reliance on the omission from general reliance on the defendant’s actions. Only the latter two are viable definitions, the first is unworkable in the Rule 10b-5 context.

The first definition of reliance on an omission follows that of reliance on a misrepresentation. Reliance on a statement means two things: first, belief in the trust of the statement, and second, action (or inaction) on that belief. Immediately two issues arise in writing a definition: How could plaintiff “believe” in an omission that, by definition, he had no knowledge of? What does it even mean for the plaintiff to “believe in an omission?” The natural answer is that an omission is like a representation that the omitted facts were not true.<sup>117</sup> For example, if A sells B a car and omits to tell B that it has no brakes, A’s omission is like a statement that the car does have good brakes. Though this is not logically rigorous, it does have a certain commonsensical charm. Thus, to “believe in an omission” is to believe in a hypothetical statement that the omitted facts were false. Given this analysis the next step, “to act or not act because of this belief in the omission” became “to act (or not act) because of the belief in the hypothetical statement that the omitted facts were false.” Under this scenario reliance on an omission would be proved by showing that the plaintiff believed the omitted facts were false and acted on that belief.

The problem with this approach is that in most cases the plaintiff probably never even thought about the omitted facts. The case of a bare omission is thus very different from the common law case of a misleading statement, where the plaintiff has a basis both for believing the falsity of the omitted facts and for proving this belief.<sup>118</sup>

In the case of the bare omission, plaintiff did not believe the facts were false—he had no belief one way or the other. However, he might be able to show that had he known the omitted facts were true he would have acted differently.

For example, in *List v. Fashion Park, Inc.*,<sup>119</sup> plaintiff sold stock to a group of people including an insider, a director of the company. In a Rule 10b-5 suit, plaintiff claimed the defendant insider had not dis-

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116. 340 F.2d 457 (2d Cir.), *cert. denied sub nom.*, *List v. Lerner*, 382 U.S. 811 (1965).

117. This is the treatment under the common law. See note 27 *supra*.

118. See text accompanying notes 205-206 *infra*.

119. 340 F.2d 457 (2d Cir.), *cert. denied sub nom.*, *List v. Lerner*, 382 U.S. 811 (1965).

closed material information, his identity as a director. The plaintiff claimed that he would not have sold the stock if he had known the identity of the defendant buyer. The district court held that there was no reliance on this omission in a suit under Rule 10b-5 because plaintiff had no belief that the buyer was not a director, thus following the definition developed above.

This harsh approach was deservedly rejected by the Second Circuit:

[W]e do not agree with . . . the trial court . . . concerning the meaning of 'reliance' in a case of nondisclosure under Rule 10b-5. [Its] opinion intimates that the plaintiff must prove he actively relied on the silence of the defendant, either because he consciously had in mind the negative of the fact concealed, or perhaps because he deliberately put his trust in the advice of the defendant. Such a requirement, however, would unduly dilute the obligation of insiders. . . .

The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.<sup>120</sup>

This *List* test is clearly not one of reliance, but one of simple causation in fact. Any "*reliance*" test would by definition have to include an element of *belief*. The Second Circuit's test does not. Instead it is precisely a "but for" causation test—if no omission then plaintiff would have acted differently. Thus, without specifically saying so, the Second Circuit did away with reliance in cases on nondisclosures, substituting the more basic causation in fact requirement.

If the *List* standard is limited to the facts of the case, involving personal dealings, it seems to be quite reasonable. However, the reasoning behind it does not seem to be dependent upon the relationship between the parties. If the standard is not so limited, then causation by a nondisclosure is really little more than that of materiality, because any reasonable man would act differently, by definition, upon being disclosed a material fact.<sup>121</sup> Not only does the *List* standard thus establish causation in most cases where materiality is present, it places almost no limits on the class of possible defendants. If the plaintiff trades without knowledge of a material fact, which would have caused him to act differently had he known it, then *all* who did not disclose the fact to him caused his injury under the *List* standard. This is true because the *List*

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120. 340 F.2d at 463.

121. This is a slight overstatement. The materiality in the Rule 10b-5 context is "whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action." *TSC Industries Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976); FED. SEC. CODE §202(92) (Proposed Official Draft 1978). Thus, the assumption that the plaintiff is a reasonable man only implies that he would consider the fact important in making his decision to enter into the transaction. Another minor assumption is needed to say he would then have not entered into the transaction. In addition, to rely he must believe the statement, another minor assumption.

test requires only an omission, not any personal contact between the parties. Thus, even Aunt Minnie from Oshkosh (regardless of whether she knew the information or not) *caused*<sup>122</sup> the plaintiff to enter into the transaction under the *List* standard, because she did not disclose the material facts to him and he would have acted differently if she had (assuming he would have believed her). Thus, causation under the *List* standard, once materiality is established, is little limitation on the Rule 10b-5 action for nondisclosure.<sup>123</sup>

Some courts have refused to reduce the causation issue to materiality by declining to follow the *List* standard. These courts have developed an alternative to *List* which may be called the General Reliance Theory.<sup>124</sup> This theory has two parts: first a *requirement* of plaintiff's "general reliance"<sup>125</sup> on the defendant before reliance on an omission can be proven.<sup>126</sup> This requirement is discussed more fully below. Second, parallel to the *List* standard, the General Reliance Theory gives a way of establishing reliance on an omission. The theory states that "general reliance" on the defendant establishes (perhaps rebuttably) specific reliance on material omission.<sup>127</sup> In the case of personal contact between the parties, the tests may give similar results. In impersonal situations, however, the results are dramatically different.

In the personal dealing case the two standards focus on slightly different factors. The *List* test is one of causation in fact. Thus, it separates the omission (the "bad action") out of the defendant's conduct, and looks to see whether that omission caused the plaintiff to enter into the transaction. The General Reliance test, on the other hand, is one of reliance or belief. It focuses on the plaintiff's reliance on all the de-

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122. Of course, Aunt Minnie had no duty to disclose and hence would suffer no liability. The point here is that she was a cause nonetheless.

123. This result is not as unusual as it may seem. In the common law of negligence a similar result occurs. Consider the case of a driver who is injured when his car runs into a train. He claims the defendant neglected to put up a "Danger—Train Crossing" sign which would have prevented the accident. Assuming the plaintiff can prove he would have stopped in time had the sign been there, there is no question that the defendant was the cause in fact of the accident. Aunt Minnie was also the cause in fact of the accident, since she did not put up the sign either. However, she will not be held liable for the damages because she was not the "legal cause" of the accident since she had no *duty* to put up the sign in that situation. See text accompanying notes 128-131 *infra*.

124. This theory, advocated in this article as the proper interpretation of *Ute* is a combination of the positive ideas of *Chasins v. Smith, Barney Co., Inc.*, 438 F.2d 116 (2d Cir. 1970), and *Mills v. Electric Auto Lite Co.*, 396 U.S. 375 (1970) with the negative ones of *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir.), *cert. denied*, 429 U.S. 1053 (1977); and *Shapiro v. Merrill Lynch*, 495 F.2d 228 (2d Cir. 1974).

125. "General reliance" means reliance on the defendant's conduct as a whole. See text accompanying notes 135-136 *infra*.

126. This "requirement" is developed in *Fridrich* and *Shapiro*. See note 124 *supra* and text accompanying notes 181-182, 197-198 *infra*.

127. This way of proving causation is developed in *Chasins* and *Mills*. See note 124 *supra* and text accompanying notes 139-143 *infra*.

fendant's actions. Given a material omission, there is a violation of the rule and since plaintiff relied on these "total" actions there is liability. This can also be viewed as the general reliance on the defendant's actions giving rise to a presumption of specific reliance on the omission.

These two definitions of "reliance" on an omission reflect basically different views on the scope of the private action under Rule 10b-5. These theories will be very important in the coming analysis of Rule 10b-5 omission cases, especially in understanding *Affiliated Ute*. Finally, theories dependent on the two views of reliance on omissions will dictate different results in the open market fraud situation.

*b. Duty*

In the common law there is very little legal cause analysis in determining transaction causation.<sup>128</sup> This is true for two reasons. First a strong form of scienter is required as an element of the tort. This intent itself creates a duty on the defendant's part to the plaintiff not to defraud him. Second, nondisclosures are not actionable at common law except in very limited circumstances. Since nondisclosures are made to everyone, in contrast to misrepresentations which are made only to a limited group, if they were actionable, some limitations on transaction causation would be needed. Thus, the plaintiff in common law actions did not have to show that the defendant had a "duty" towards him,<sup>129</sup> proof of transaction causation was enough.

In the private actions under Rule 10b-5, on the other hand, a "duty" or legal cause analysis is needed. Scienter under the rule is only a comparatively toothless remnant of the common law of fraud. Nondisclosures are actionable in a great variety of situations. Since, under the *List* test,<sup>130</sup> a nondisclosure can "cause" an almost unlimited number of plaintiffs to enter into transactions and because the focus of a scienter now has little to do with intent *vis à vis* a particular plaintiff, a limitation on causation in fact is required to reduce the class of possible claimants.

"Duty" therefore became an element of proving Rule 10b-5 cases for nondisclosure.<sup>131</sup> That is, plaintiff has to show, as a threshold issue, that defendant had a duty to disclose the nondisclosed information to him. This duty requirement might have been described as a part of

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128. See text accompanying notes 121-123 *supra*.

129. In two of the ways a nondisclosure can be actionable some sort of "duty" must be proved. See text accompanying notes 15-27 *supra*.

130. See text accompanying notes 121-123 *supra*.

131. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972); *Shapiro v. Merrill Lynch*, 495 F.2d 228, 235-38 (2d Cir. 1974); *Chasins v. Smith, Barney & Co., Inc.*, 438 F.2d 1167, 1171 (2d Cir. 1970).

“legal cause” analysis in the common law; in this case, “legal cause” is the transaction causation link of the causal requirement. It can be more simply thought of as just another element of the action.

The problem that arises with this duty question is not whether it is a separate element of the private action or merely a part of transaction causation, but whether it has any bearing on causation in fact. Which-ever way it is considered there is no ambiguity—duty is completely independent of causation in fact. Yet, in the cases to follow, the Supreme Court and the Second Circuit Court of Appeals get somewhat confused on this point.

c. *The Chasins Case*

The foundation for the Supreme Court’s reasoning in *Affiliated Ute* was the Second Circuit’s decision in *Chasins v. Smith, Barney, & Co., Inc.*<sup>132</sup> This case involved the purchase by plaintiff Chasins of stock on the recommendation of his broker, Smith, Barney & Co., Inc. The defendant brokerage firm sold him the stock without disclosing to Chasins that it was acting as a market maker<sup>133</sup> in the stock. In Chasins’ Rule 10b-5 suit for his losses in the stock, the Second Circuit held that the omission was material.

The Court then addressed the causation issue:

To the extent that reliance is necessary for a finding of a 10b-5 violation in a non-disclosure case such as this, the test is properly one of tort ‘causation in fact.’ *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969). Chasins relied upon Smith, Barney’s recommendations of purchase made without disclosure of a material fact, purchased the securities recommended, and suffered a loss in their resale. Causation in fact or adequate reliance was sufficiently shown by Chasins.<sup>134</sup>

Understanding this passage is a key to understanding *Affiliated Ute*, since the Supreme Court cites *Chasins* in the most crucial stage of its treatment of causation.<sup>135</sup> The first sentence quoted is easy to accept. This is the Court’s earlier conclusion in *List*. Oddly enough, however,

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132. 438 F.2d at 1167.

133. In the Court’s words this meant that Smith, Barney “was maintaining a position in the stocks on its own account by participating in over-the-counter trading in them.” *Id.* at 1170. The Court quoted LOESER, *THE OVER THE COUNTER SECURITIES MARKET WHAT IT IS AND HOW IT OPERATES*, 5-6 (1940):

A dealer engages in ‘creating and maintaining a market’ for securities. [It] ‘creates a market for a security’ when it is prepared both to buy and sell that security at the price it quotes, and it ‘maintains’ such a market when it continues over a period to quote the prices at which it is ready to buy and sell.

LOESER, *supra*, at 5-6; see also FED. SEC. CODE §202(91) (Proposed Official Draft 1978) (definition of “marketmaker”) and SEC Rule 17a-9(f)(1), 17 C.F.R. §240.17a-9 (1980).

134. 438 F.2d at 1172.

135. 406 U.S. at 154.

*Crane* is cited and *List* is not. *Crane* certainly held that causation in fact is the issue and not reliance, but it did so in a very different context, when reliance was impossible. Anyway, the sentence is sensible, though it is somewhat misstated. The Court should have said more accurately that reliance need not be proved in 10b-5 actions if causation in fact can be established directly. Reliance itself is just a way of showing causation in fact, reliance cannot be established by proof of causation in fact.

If the Court were to be consistent with *List* (which it completely ignores) it would now determine whether or not Chasins would have bought the stock if the fact of Smith, Barney's market making had been disclosed. However, the Court does not so determine. "Chasins *relied* upon Smith, Barney's *recommendations* of purchase made without the disclosure of a material fact . . . and suffered a loss . . . . Causation in fact or adequate reliance was sufficiently shown . . . ." <sup>136</sup>

In other words, causation in fact was shown by Chasins' reliance on the recommendations made without the disclosure of a material fact. The Court focuses not on causation by the omission itself, but on causation by the recommendations *and* omission, that is, all of defendant's conduct. To conclude that causation in fact is established the Court is not concluding that without the omission there would have been no sale, but rather, without Smith, Barney's "total conduct" there would have been no sale. The former would have necessitated a *List* analysis which does not appear. The latter is obvious.

The Court treats the recommendations with an omission of material fact precisely as if the total conduct was one misrepresentation. Chasins relied on the conduct, therefore causation is established. Thus, the Second Circuit has adopted what is described above as the General Reliance test. That is, Chasins generally relied on Smith, Barney, therefore, specific reliance on the omission is not required to be proved to establish the requisite causal element.

It is curious that the same court decided *List* and *Chasins*, espousing very different standards for reliance on an omission. However, the two cases can be explained consistently with the assumption that the General Reliance test does not establish causation conclusively, but merely raises a rebuttable presumption of it. That is, general reliance on the conduct of the defendant raises a *presumption* of specific reliance on the material omission. This presumption could be rebutted by proof that the omission by itself did not cause the transaction to take place using the *List* standard. Since the *List* opinion found no reliance and *Cha-*

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136. 438 F.2d at 1172 (emphasis added).



*sins* did find reliance, this theory is consistent with both cases. It is not, however, necessarily required by the language in either case. That is, there was no mention of a "presumption" in either case.

This rebuttable presumption removes what might be thought of as a flaw from the General Reliance Theory. If it is possible under the theory to have nonreliance under the *List* test (actual noncausation) while having causation under the General Reliance Theory, it seems that the *List* test is better. The presumption solves this problem.

An examination of the role of materiality in the *Chasins* analysis of causation is necessary before one can understand *Affiliated Ute*. Though materiality is evidence of reliance and hence causation, in the quoted passage materiality is used only to show that there was a violation of Rule 10b-5, the omission of a material fact, not in any sense to imply causation. That is, the Court stresses that Chasins relied on recommendations without the disclosure of a material fact. His general reliance establishes (perhaps only presumptively) causation. The materiality only establishes a violation of Rule 10b-5. So his entering into the transaction was caused by a violation of the rule. It is crucial to notice that under the Court's analysis, there would have been no less causation if the omitted fact had not been material; there just would have been no violation of the rule. The court *in no way* uses materiality to imply that Chasins would have acted differently if the fact had been disclosed. This is irrelevant to the Court's analysis of causation. It is enough for the Court that Chasins would not have entered into the transaction without his general reliance.

Materiality may play an additional role in the Court's discussion of causation, though the following theory is not explicitly supported by the language. Materiality not only establishes a violation of the rule, it establishes a violation of the rule that is important enough so that its "punishment" will further the interests of the rule.<sup>137</sup> This, of course, is the purpose of materiality—to insure that only "important" violations are remedied by the law.

Given a nondisclosure of a material fact, it is in furtherance of the deterrent purposes of the rule to impose liability on the defendant.<sup>138</sup> Therefore, it makes sense to weaken the causal requirement by only

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137. This theory is explicitly stated in *Mills v. Electric Auto Lite Co.*, 396 U.S. 375, 384 (1970) and discussed more fully in the text accompanying notes 145-150 *infra*.

138. See 396 U.S. at 384. The materiality requirement adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by Sec. 14(a).

*Id.*

requiring general reliance instead of specific reliance or, more elegantly, specific reliance from general reliance, thus shifting the burden on the causation issue to the defendant, upon proof of general reliance. Stated simply, the theory is that materiality establishes that the defendant committed a "bad act." Since society has an interest in deterring "bad acts," the causal requirement is softened to general reliance or the burden of proof is shifted upon proof of general reliance. This theory is used by the Supreme Court in *Mills v. Electric Auto Lite Co.*<sup>139</sup>, a case very similar to *Chasins*. *Mills* will be discussed more fully below.

Another significant theory in this area is based on the *List* test and so is quite different from General Reliance. This theory, that of "Implied Reliance" is not present in the reasoning of *Chasins*. It is useful, however, to consider it in the *Chasins* context to provide a basis for understanding its supposed application in *Mills* and *Affiliated Ute*.

The basic Implied Reliance Theory is simple. Materiality of an omission means that a reasonable man would have found the omitted fact was important in making his decision. Therefore, once materiality is established, plaintiff really only needs to show he would have acted reasonably to show causation in fact under the *List* test.<sup>140</sup> This small assumption of reasonableness thus implies a presumption of causation from materiality. This small assumption can be justified by the otherwise difficult proof of reliance on an omission. To meet the *List* test plaintiff must show that he would have acted in a certain way in a hypothetical situation, i.e., if the omitted facts had been disclosed to him. This proof is difficult in two ways. First, the plaintiff may have trouble convincing the fact finder of his reactions to a hypothetical situation.<sup>141</sup> Second, the value of such hypothetical proof may be only of doubtful worth.<sup>142</sup> Therefore, since it has already been shown that the defendant violated the rule, the small assumption should be made to help the plaintiff.<sup>143</sup> This would then raise a presumption of reliance or causation in fact from materiality. A refinement of the theory suggests that the presumption should only be rebuttable.<sup>144</sup> This "presumption" might be why the causal requirement is relaxed in *Chasins*.

This theory gained great acceptance as an explanation of *Affiliated Ute* and *Mills*.<sup>145</sup> It does not, however, accurately describe the reason-

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139. 396 U.S. 375 (1970).

140. See note 121 *supra*.

141. 3 BROMBERG & LOWNEFELS, *supra* note 2, §8.6, at 209-11.

142. 3 BROMBERG & LOWNEFELS, *supra* note 2, §8.6, at 209-11; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 590 (1975).

143. Other reasons such as the large number of voters in a proxy contest may be given in special circumstances. See 396 U.S. at 385.

144. 3 BROMBERG & LOWNEFELS, *supra* note 2, §8.6, at 212.

145. See note 153 *infra*.

ing in *Chasins*. The court in *Chasins* gives no indication that materiality might justify a presumption of reliance. There is, in fact, no such presumption. The court still requires proof of reliance on the total conduct of the defendant. In addition, this theory is so revolutionary in nature that it is hard to believe that the court would use it without any discussion.

A final note on this introduction to General Reliance and Implied Reliance is in order: given a situation where general causation or reliance is obvious, as in most direct dealing situations, the basic causal link is already established. Thus, causation is established if the General Reliance Theory applies. But the theory applies whenever there is an omission of a material fact. Therefore, given a situation in which there is general reliance and an omission, the only remaining proof necessary to establish causation is materiality. In this sense then, given general reliance and an omission, materiality establishes causation in fact (though perhaps only presumptively). Therefore, where these elements are present the implication of causation from materiality under the General Causation Theory is very like that of the Implied Reliance Theory. In fact, wherever there is general reliance e.g., in most direct dealing situations, the theories give the same result. Where there is no general reliance, however, the opposite result occurs.

Even though the two theories give similar results in most cases, they are theoretically very different. The Implied Reliance Theory implies reliance from materiality. So, in a sense, causation does not have to be shown for this theory, only materiality does. The General Reliance Theory, though it may appear to require only a material omission in situations of general reliance, still requires proof of a causal connection, general reliance itself.

The *Chasins* opinion is of great importance in the analysis that follows. It is therefore important to keep in mind the holding and reasoning of the case. *Chasins* is a clear example of the General Reliance Theory; it contains no reference to the ideas of Implied Reliance.

#### *d. The Mills Case*

In 1970, shortly before the decision in *Chasins*, the Supreme Court decided a quite similar case in *Mills v. Electric Auto-Lite Co.*<sup>146</sup> These two cases normally are thought to form the basis for the *Affiliated Ute* decision. Defendants in the *Mills* case made a material omission in a proxy statement which called for approval of a merger. Plaintiff sued

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146. 396 U.S. 375 (1970).

under Rule 14a-9<sup>147</sup> after the merger was approved, claiming to be injured because the terms of the merger were unfavorable. The crucial issue in the case was that of causation, whether or not the omission caused the merger to be approved. The Supreme Court held that plaintiff did not have to prove that individuals voting a certain number of shares “relied” on the omissions. The Court noted that the materiality requirement embodies

a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9 and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by §14(a).<sup>148</sup>

Having decided that imposition of liability would further the purposes of Section 14(a), the Court imposed a low causal standard:

There is no need to supplement this requirement . . . with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress, if, as here, he proves that the proxy solicitation itself, rather than the particular defect, . . . was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.<sup>149</sup>

The Court’s reasoning in this case is the same as that of the General Reliance Theory of *Chasins*. Given materiality, the Court requires only general reliance, i.e., that the proxy statement itself was a cause in fact of the transaction. In addition, the court affirms the role of materiality in the General Reliance Theory proposed in the discussion of *Chasins*.<sup>150</sup> Just as in *Chasins* the Court never tries to determine whether the omission itself caused the transaction. The Court does not even

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147. SEC Rule 14a-9, 17 C.F.R. §240.14a-9 (1980) (promulgated under §14(a) of the Securities and Exchange Act of 1934, 15 U.S.C. §78n(a) (1976)), prohibits fraud in the solicitation of proxies. Though *Mills* was not a Rule 10b-5 case, the rules are similar and the reasoning of the cases seems applicable to Rule 10b-5 situations.

148. 396 U.S. at 38 (footnotes omitted).

149. *Id.* at 384-85 (citations omitted).

150. See text accompanying notes 137-138 *supra*.

mention the *List* test. Instead the Court decides, exactly as in *Chasins*, that, given a material omission, the causal connection to be established is not between the omission and the transaction, but between the whole proxy statement (the “total conduct”) and the transaction: “Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury . . . if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an *essential link in the accomplishment* of the transaction.”<sup>151</sup>

Unlike the Second Circuit in *Chasins*, the Supreme Court discusses its justification for this result. The Court notes that materiality means that the omitted fact was such that it might have been considered important by a reasonable shareholder. The conclusion from this observation is that the omission fit the Rule 14a-9 requirement that the defect have a “significant propensity to affect the voting process.” This requirement “adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of a liability would not further the interests protected by Section 14(a).”<sup>152</sup> In other words, at this point the Court has decided that the omission was important enough to violate the rule and that correction of, or liability from, such an important violation would further the interests of the rule.

To this point, the Court mirrors the *Chasins* theory. Having decided the omission merited correction or liability, the Court found it easy to lower the causal standard to allow proof of only reliance on the “total conduct,” the proxy statement. Thus, under this analysis, the Supreme Court appears to have followed the General Reliance Theory exactly.

An additional reason for the lower causal standard in *Mills* is given by the Court:

This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.<sup>153</sup>

This additional reason for easing the plaintiff’s burden is in accord with the ideas of the General Reliance Theory, that, given general reliance, the causal connection should be presumed.

Unfortunately, the *Mills* case has been interpreted as a manifestation

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151. 396 U.S. at 385 (emphasis added).

152. *Id.* at 384.

153. *Id.*

of the Implied Reliance Theory proposed for *Chasins*. These interpretations flatly claim that the case says that materiality establishes a presumption of reliance.<sup>154</sup> They rationalize this result by the difficulty of proof of individual reliance by large numbers of shareholders, the difficulty of proof by a reliance on an omission, and the small distance between reliance and materiality. This is a nice theory, but just as in *Chasins* it is not supported by the language of the case. The Court does not speak of any “presumption of reliance” except in the context of general reliance. Proof that the proxy materials were an “essential link,” i.e., a cause in fact, of the transaction is the crucial requirement of the holding. The Court’s discussion of materiality only leads to the conclusion the omission was of the type rightly “punished” by the rule. This discussion says nothing at all about any implication of reliance from materiality through the *List* standard. Given that the General Reliance Theory is so strongly supported by the language, this Implied Reliance Theory is untenable. Yet, it is the accepted interpretation of *Mills*.

The two theories clash again in the interpretation of *Affiliated Ute*. Unfortunately, the opinion in that case is so unclear that it is impossible to determine the role of materiality in the context of causation. Since the *Affiliated Ute* case is apparently based on *Mills* and *Chasins*, however, the role of the General Reliance Theory in these cases indicates that the correct interpretation of *Affiliated Ute* is one based on that theory.

### 3. Affiliated Ute

In *Affiliated Ute Citizens v. United States*,<sup>155</sup> plaintiffs Ute Indians were solicited by a bank and its employees to sell stock in their native corporation. When the Indians did sell the stock the purchasers did not disclose to the unsophisticated sellers that they were promoting another market for the stock and selling it for a higher price. Unable to show that they relied on the fraudulent nondisclosures, the plaintiffs failed to

154. See, e.g., *Vervaecke v. Chiles, Heider & Co., Inc.*, 578 F.2d 713, 717 (8th Cir. 1978); *Holdsworth v. Strong*, 545 F.2d 687, 695 (10th Cir. 1976); *Chelsea Assoc. v. Repanos*, 527 F.2d 1266, 1271 (6th Cir. 1975). These are just examples. Practically every case citing *Ute* could serve just as well. Explanations of the purpose of the presumption vary: to alleviate plaintiff’s difficulty—*Lewis v. McGraw*, 619 F.2d 192 (2d Cir. 1980); *Adato v. Kagan*, 599 F.2d 1111 (2d Cir. 1979); *Titan Group, Inc. v. Fagen*, 513 F.2d 234, 238 (2d Cir. 1975), *cert. denied*, 423 U.S. 840 (1975); for conceptual difficulties—527 F.2d at 1271; *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975); large number of plaintiffs—*Christ-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 375 (2d Cir. 1973); express proof of reliance on omission “obviously” impossible—*Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856 (10th Cir. 1980); *accord*, *Sharp v. Coopers E. Lybrand*, 649 F.2d 175 (3d Cir. 1981).

155. 406 U.S. 128 (1977).

prevail in their 10b-5 claim for damages in the Tenth Circuit.<sup>156</sup> The Supreme Court granted *certiorari* and reversed the Tenth Circuit, holding for the plaintiffs.

The Court first decided that given the bank's solicitation of the plaintiffs, there was an obligation to disclose their market making activities.<sup>157</sup> The Court then turned to the issue of causation:

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. See *Mills v. Electric Auto Lite Co.*, 396 U.S. 375, 384 (1970), *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (CA2 1968), cert. denied sub nom., *Coates v. SEC*, 394 U.S. 976 (1969). 6 L. Loss, Securities Regulation 3876-3880 (1969 Supp. to 2d ed. of Vol. 3); A. Bromberg, Securities Law, Fraud-SEC Rule 10b-5, §§2.6 and 8.6 (1967). This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

*Chasins v. Smith, Barney & Co.*<sup>158</sup>

The holding of the Court is clear. In certain circumstances, materiality will "establish" causation in fact. To determine the scope of this result, the motivations for it must be understood. Unfortunately, this paragraph raises difficult problems of interpretation. It is very hard to decide exactly what the Court means, or even how its conclusions follow from its premises. Since no explanation is given for these conclusions, it is necessary to turn to the authority cited for each step to attempt to understand what motivated the decision. This study indicates that the decision is dependent on the *Chasins-Mills* General Reliance Theory and thus should be limited in its application to situations where general reliance is present.

As demonstrated below, the *only* case cited for the actual reasoning of this case is *Chasins*. That is sensible. *Chasins* was correctly decided and *Affiliated Ute* is, in every important aspect, *identical* to *Chasins*. Both cases involve nondisclosure of a material fact (the defendant's market making) by a defendant who solicited the plaintiff's dealings (though in *Chasins* the plaintiff's purchase was solicited; in *Affiliated Ute* the plaintiff's sale was solicited). In both cases, given the solicitation, there was no question that the defendant's actions induced the plaintiff to enter into the transaction. This is crucially important. In both cases the defendant's "total actions" were clearly the cause in fact of the plaintiff's entering the transactions. If the defendants had not

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156. *Revos v. United States*, 431 F.2d 1337, 1348 (10th Cir. 1970).

157. 406 U.S. at 153.

158. *Id.* at 153-54.

solicited the plaintiffs, no transaction would have taken place. Thus, general reliance was obvious in each fact situation.

The real causation question, therefore, in both cases was: Given that the defendant's "total conduct" was a cause in fact of the plaintiff's entering into the transaction, must the plaintiff additionally show that the omission itself was also such a cause in fact?

The *Chasins* court, of course, concluded that as long as there was a violation of the rule, as shown by the materiality of the omission, the plaintiff did not have to meet the stricter causal standard (or at least that there was a shift of the burden of proof). In *Mills* the Supreme Court came to the same conclusion, though whether the "total conduct" caused the transaction remained to be proven.

In *Mills*, the need for the materiality requirement was emphasized by the discussion indicating that as long as there was materiality it made good sense to punish the defendant.<sup>159</sup> To follow this *Chasins-Mills* theory, then, the Court merely had to find a violation of Rule 10b-5, because the relaxed causal connection was already established. To do this the Court need only find an obligation to disclose and the withholding of a material fact. This would establish causation under the *Chasins-Mills* General Reliance Theory (or the presumption thereof).

This reasoning seems to fit the language of *Affiliated Ute* reasonably well. The Court first announces that in the circumstances of this case, involving primarily nondisclosures, "positive" proof of reliance is not necessary.<sup>160</sup> This is certainly true according to *Chasins* if one interprets "the circumstances of this case" to mean "where there was such a close relationship that general reliance was clear" and reliance to mean "reliance on the omission," which seems clearly to be what the Court means (especially since reliance on the defendant's total conduct is obvious).

The Court continues "[a]ll 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."<sup>161</sup> For this proposition the Court cites four authorities. It is not clear from the context which proposition in the sentence is supported by the citations, either "all that is necessary is that the facts withheld be material" or "material in the sense that a reasonable investor might have considered them important in the making of this decision."

The first cite is to *Mills* at page 384. This part of *Mills* does not

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159. 396 U.S. at 384.

160. 406 U.S. at 153.

161. *Id.* at 153-54.



address the causal issue (though a cite to pages 384-85 might have). It is merely the definition of materiality. Consistently, the next cite, to *SEC v. Texas Gulf Sulphur*,<sup>162</sup> is only to a definition of materiality. The third cite is to part of Professor Loss' treatise, *Securities Regulation*. The cite is to four pages of the Supplement to the Second Edition of Volume Three. This cite is somewhat mysterious. Within these four pages (a discussion of reliance) there are only three references to materiality. One, on page 3879, is inapplicable. Thus, the cite must refer to the two cites on page 3877.

Echoing the British habit of blurring reliance and materiality (see p. 1703 *supra*), a District Court has posed the historical question:

If a plaintiff does not rely on the data he was furnished, how can he say that the undisclosed data was material or that the data he was furnished was "in the light of the circumstances" misleading?<sup>163</sup>

This cite gives no support for either of the two propositions in the sentence. In particular, note that it gives no support to the notion implying reliance from materiality. It is very odd that it was included. An explanation for the proper role of the cite is given below.<sup>164</sup>

The final cite may be meaningful. The cite is to Professor Bromberg's treatise, the relevant part of which may be (though in a three page section this paragraph is the only applicable part); "Alternatively reliance may be presumed from materiality. There is some judicial acceptance of this view, and it makes sense; once the latter is shown, the reasonably prudent investor would be expected to rely."<sup>165</sup>

If the Court meant to make reference to this passage it could have done so more clearly. At any rate this is an indication that *Affiliated Ute* is a deviation from *Chasins*, an affirmation of the Implied Reliance Theory as opposed to that of General Reliance. This will be discussed more fully below.

The sentence itself does fit nicely into the General Reliance Theory. Since "general reliance" has been established, and an obligation to disclose already shown to be required, all that is needed is materiality to fit the theory to establish causation in fact.

The Court concludes, "[t]his obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact," citing *Chasins*.<sup>166</sup> Thus, *Chasins* is the only case cited for the

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162. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.*, Coates v. SEC, 394 U.S. 976 (1969).

163. 6 Loss, *supra* note 2, at 3877 (citing Kohler v. Kohler, 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963)).

164. See text accompanying notes 168-169 *infra*.

165. 3 A. BROMBERG, SECURITIES LAW: FRAUD-SEC RULE 10b-5, §8.6(2), at 212 (1967) (footnotes omitted).

166. 406 U.S. at 154.

reasoning<sup>167</sup> of the Court. The conclusion of course fits the General Reliance Theory perfectly. Since *Chasins* stands only for the ideals of the General Reliance Theory, that theory must be the correct interpretation of the *Affiliated Ute* opinion.

However, the weak reference to Professor Bromberg may imply that some notion of the Implied Reliance Theory is present in the opinion. It seems very hard to accept, though, that the Court would base its decision on this paragraph from Bromberg without a clearer reference to it or discussion of this revolutionary idea. In addition, the final reference to *Chasins* is flatly contradictory to any suggestion that *Affiliated Ute* uses the ideas of the Implied Reliance Theory. At any rate, the Implied Reliance Theory has become the accepted theory of *Affiliated Ute*. At this point it is hard to conclude that there is much more support for the theory in *Affiliated Ute* than there was in *Mills* or *Chasins*.

Fortunately, there is an additional clue to the analysis of *Affiliated Ute*. The crucial passage in the case is so close to a passage in one of the briefs in that case that it must have been copied from it. Fortunately this "original" passage is much clearer than that in the *Affiliated Ute* decision.

In the Brief for the United States and Brief for the Securities and Exchange Commission as *amicus curiae* in *Reynos*<sup>168</sup> the following passage occurs:

In addition, at least in the circumstances of this case where the misconduct involves a failure to disclose material facts rather than the making of affirmative statements that are false and misleading, proof of reliance is not a prerequisite to recovery; it is wholly conjectural whether an investor would in fact have acted differently had he been advised of all material facts. (See Bromberg, *Securities Law: Fraud-S.E.C. Rule 10b-5*, part 8.6, p. 209; 6 Loss, *Securities Regulation* 3878-3880 (1969). *List v. Fashion Park, Inc.* 340 F.2d 457 (C.A.2), is not to the contrary.) In such situations, it is necessary only that the facts withheld be "material"; that is, information a reasonable investor "might have . . . considered important" in determining his course of action. *Mills v. Electric Auto Lite Co.*, 396 U.S. 375, 384; see also *Securities and Exchange Commission v. Texas Gulf Sulphur*, 401 F.2d 833, 849, *Certiorari denied sub. nom. Coates v. Securities and Exchange Commission*, 394 U.S. 976. If the defendant owed an obligation of disclosure, and if it is shown that "material" facts were withheld, this proof suffices to establish the requisite element of causation in fact. *Chasins v. Smith, Barney & Co.*, *supra*, 438 F.2d at

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167. The *Mills* and *Texas Gulf* cites are merely references to the definition of materiality.

168. *Reynos* was one of the actions amalgamated to make up the *Affiliated Ute* case. See note 155 *supra*. [This brief is hereinafter cited as Brief].

1172 (footnote added to text).<sup>169</sup>

It is obvious that the Court's discussion is based on this passage from the SEC brief. In fact, it is obvious that the quoted part of the *Affiliated Ute* opinion is a *paraphrase* of this passage. Therefore, an analysis of the reasoning in this passage should shed light on the reasoning in *Affiliated Ute*.

The first sentence may clear up an ambiguity of *Affiliated Ute*. "[I]n the circumstances of this case" refers fairly explicitly here to omissions as opposed to misrepresentations, not to the total circumstances of the case. Of course, this does not mean that the circumstances do not affect the decision.

Even more importantly this first sentence cites Professors Loss and Bromberg, but for a much less controversial point than does the *Affiliated Ute* passage. In *Affiliated Ute* the cites are delayed until the next sentence referring to materiality. Here, the authorities are cited for one of two statements, either that proof of reliance is not a prerequisite to recovery or that such proof is highly conjectural. The Loss cite here is only to pages 3878-80. This section refers to causation as opposed to reliance, advocating the former as the standard. It thus refers to both proposed statements. The cited section, it should be noted, does not relate to materiality; even the marginal cite in 3876-78 is omitted. The Bromberg cite also discusses causation in place of reliance. Though the materiality language quoted above is contained in the cite, nothing in the SEC brief singles it out.

The net result is that neither authority in the SEC brief is seemingly cited for the "materiality implies reliance" idea. The use of the Loss cite makes sense in this context when it did not in the Court's opinion. The logical conclusion is that both cites should be read to stand as they do in the SEC brief, not the Court's opinion. This leaves the Implied Reliance Theory with absolutely no support as an explanation for *Affiliated Ute*. The General Reliance Theory which fits the SEC language well, must have been the basis for the opinion.

The next sentence is even more revealing. As noted above, the *Mills* and *Texas Gulf Sulphur* cites refer only to the definition of materiality. In the SEC brief the definition is quoted thus giving definite proof that this definition is all that *Mills* is cited for. This important point helps defeat the Implied Causation view—*Mills* is not cited to support that idea, in fact *no case is*.<sup>170</sup>

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169. Brief, *supra* note 168, at 66-67.

170. This is an important point because many courts which use the Implied Reliance Theory for *Ute* do so because that is their interpretation of *Mills* also, and they think that *Ute* cites *Mills* for its reasoning. This discussion convincingly indicates, however, that *Mills* was not involved in

The last sentence is again clearer than that of *Affiliated Ute*. The “proof” that suffices to show causation is the “show[ing] that material facts were withheld” given a duty to disclose. The duty to disclose does not help prove causation, as might be inferred from *Affiliated Ute*, materiality does. Since only *Chasins* is cited for this proposition, the conclusion must be that *Chasins* is the basis for the reasoning. *Chasins*, however, applies only to the General Reliance Theory and thus, since the SEC brief has no reference to it, the conclusion follows that the theory is an erroneous interpretation of the brief and hence the *Affiliated Ute* decision.

At this point it is worth re-examining the basic theoretical difference between the two theories. The Implied Reliance Theory implies reliance or causation from materiality. It is thus tantamount to the elimination of the causal requirement. The General Reliance Theory, on the other hand, still requires proof of reliance, though not of specific reliance. There is thus a fundamental difference in the two theories and their approach to causation. Though they seem to agree where general reliance is present, in its absence they give directly opposite results.

#### 4. *Implied or General Reliance?*

Though the conclusion is reached above that the General Reliance Theory is the basis of the *Affiliated Ute* decision, this theory has not been generally accepted. Instead the Implied Reliance Theory seems to be the basis of most courts application of the *Affiliated Ute* holding. In ordinary cases, however, the choice of theories is unimportant. In any case involving general reliance the two theories apply *Affiliated Ute* in the same way,<sup>171</sup> requiring only a material omission to establish liability if there is an obligation to disclose.

The reason for the failure of the General Reliance Theory to gain acceptance is simple. The *Affiliated Ute* opinion is so confusingly written that a good deal of thought is needed to understand its dependence on *Chasins*. It is much easier to accept its literal holding without understanding the limitations on it imposed by its justification. The literal holding, of course, is “in a case of nondisclosures, an obligation to disclose and materiality imply causation in fact.” Though this holding

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the court’s reasoning, except as an example of the definition of materiality. See, e.g., *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 374-75 (2d Cir. 1973). Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 586 (1975). Of course, even if *Mills* were cited for the “Materiality implies reliance” idea, it has been shown that *Mills* endorses the idea only in the context of general reliance.

171. But see text accompanying notes 219-221 *infra*.

makes no sense<sup>172</sup> when read literally, it is easy to apply, and so has been used.

A major reason for the acceptance of the Implied Reliance Theory is that the one line holding of *Affiliated Ute* seems to support it. The holding and theory reach the same conclusion, that materiality establishes causation in fact. In contrast, the General Reliance Theory is stated quite differently—in the circumstances, involving general reliance, specific reliance on the omission need not be proved if the omission is material. On the surface, this does not seem to agree with the holding of *Affiliated Ute*, though the conclusion above is that it is the true interpretation.

The reasoning of *Affiliated Ute* is generally explained under the Implied Reliance Theory in this way: the reasoning of *Affiliated Ute* is indecipherable. Therefore, working back from the conclusion which does make sense, one must replace “in the circumstances of this case” with “in a case involving omissions” (note this is probably correct according to the SEC brief) and ignore the obligation to disclose (this becomes a “duty” question to be decided separately). Then replace “causation in fact” with “reliance” and “establishes” with “establishes a presumption of.” Thus, the “holding” of *Affiliated Ute* as interpreted under the Implied Reliance Theory is “in cases involving nondisclosures, materiality of the nondisclosed facts establishes a presumption of reliance.”<sup>173</sup> This holding can “only” be explained, as discussed above, by the difficulty of showing reliance on an omission and the closeness of materiality to reliance.<sup>174</sup>

It is obvious that this theory is highly artificial. It does not seem to be supported by the language of the case at all. Yet, this is now the accepted theory, and, as such, it is worth examination.

#### *a. Application of the Implied Reliance Theory*

Given that a court is to use the Implied Reliance Theory, it first must determine the proper framework for its decision. This framework is not clearly given by the *Affiliated Ute* opinion. The first step a court must take is to decide if the theory is to apply at all. This merely requires a finding of omissions. Under the General Reliance Theory, of course, much more is needed, especially in terms of the relationship between the parties. In the Implied Reliance Theory, the relationship between the parties is irrelevant.

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172. A duty to disclose can have no effect on causation in fact, see text accompanying notes 175-176 *infra*.

173. See note 53 *supra*.

174. See note 153 *supra*.

Upon a finding of omissions the Court must consider the *Affiliated Ute* holding, which raises problems immediately. "This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."<sup>175</sup> This line is open to two quite different interpretations. First, which appears to be more logical, it can be interpreted as "Given the withholding of a material fact, causation is in fact established or presumed. Since there was also an obligation to disclose, that is, a violation of a *duty*, the defendant is liable." This is quite a stretching of the language of the Court, but it at least makes sense. It is, in fact, in accord with the basic assumptions of the Implied Reliance Theory. In its analysis of the presumption of reliance (causation) from materiality there is no place for duty. Unfortunately, the clear language of the Court must be quite twisted to get this result.

However, the literal reading of the statement seems to make no sense at all under the Implied Reliance Theory (Of course, the General Reliance Theory explains the statement nicely. In that theory, duty just establishes a violation, it does not imply causation.). The literal reading implies that an obligation to disclose helps to establish causation in fact. Clearly an obligation cannot cause anything and it is hard to see how it could help prove that there was causation in fact. An argument may be made that both the obligation to disclose and materiality help show that the plaintiff actually relied on the nondisclosure and hence there was causation in fact. It is easy to see why materiality indicates reliance, that requires only the assumption that the plaintiff is a reasonable man. Conceivably, the obligation to disclose may indicate that there is a somewhat "close" that is, face to face, relationship between the parties and thus that the plaintiff was more likely to rely on the nondisclosure or that the plaintiff, aware of the duty, expected disclosure.<sup>176</sup> These explanations seem very weak.<sup>177</sup>

The clear language of the court, that *there must be a duty to disclose* information before a nondisclosure is a cause-in-fact of plaintiff's action, is utterly, unarguably *wrong*. Causation in fact is and must be totally separate from any idea of duty. Therefore, most courts using the Implied Reliance Theory brush over this difficulty and treat the

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175. 406 U.S. at 54.

176. In the common law, two types of nondisclosures are actionable because of the duty between the parties, the case of fiduciary duty and the case of plaintiff's expectation of disclosure of facts basic to the transaction due to the customs of the trade. In both these situations, plaintiff may be said to rely on the "duty." However, this is not really true. The plaintiff actually is relying on this relationship with the defendant not on any legal "duty." In any case, this reliance is a case of "general reliance," so the Implied Reliance Theory is not needed to imply causation.

177. The SEC Brief presents its final sentence in such a way as to avoid controversy. "If the defendant owed an obligation of disclosure, and it is shown that "material facts" were withheld, this proof suffices to establish the requisite element of causation in fact." Brief, *supra* note 167, at 67.

duty requirement as a separate one from causation in fact. That is, materiality implies causation in fact but duty is also needed before liability. This makes sense in practice, if not as an interpretation of *Affiliated Ute*.<sup>178</sup>

The framework for analysis of the Implied Reliance Theory, then is: first the court must determine if there are omissions; second, it must decide if the omissions are material, thus implying causation in fact; and finally, it must decide if there is a duty to disclose in the circumstances such that the defendant should be liable for plaintiff's losses. Several decisions which follow *Affiliated Ute* have difficulty with this framework.<sup>179</sup>

*b.* Simon v. Merrill Lynch

One of the first cases to interpret *Affiliated Ute* rejected the Implied Reliance Theory in favor of the General Reliance Theory. In *Simon v. Merrill Lynch*,<sup>180</sup> plaintiff customer brought a Rule 10b-5 suit against his broker, charging that Merrill Lynch knew of the precarious financial position of a company, but continued to recommend its stock up to the time plaintiff had bought the stock without relying on any misrepresentations made by the defendant. On appeal, the plaintiff argued that, since the defendant had a duty to disclose the information to him and had withheld that material information, proof of reliance was not necessary under *Affiliated Ute*.

The Fifth Circuit rejected this argument:

We think the finding that plaintiff did not generally rely upon the broker for advice makes the principle asserted by Simon inapplicable here. Although *Ute* does state that a plaintiff need not specifically demonstrate reliance on particular omissions, that case did not involve, as here, a general lack of reliance by the plaintiff on the defendants' representation. In *Ute*, concerning the management and distribution of the Indian tribe's assets, the Court acknowledged that the plaintiffs 'considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares'. . . . The Court made clear that 'if [defendants] had functioned merely as a transfer agent, there would have been no duty of disclosure here.' . . . [S]ome element of general reliance by plaintiff, even in nondisclosure cases is essential to a Rule 10b-5 action. . . . Simon made his own investment decisions and relied in no way on defendant's recommendations. The . . . requirement of reasonable reliance, therefore, was not met. Nor does *Cha-*

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178. See text accompanying notes 128-131 *supra*.

179. See *Shapiro v. Merrill Lynch*, 495 F.2d 228 (2d Cir. 1974).

180. 482 F.2d 880 (5th Cir. 1973).

*sins, supra*, provide him with support because the Second Circuit limited that opinion to the fact situation where the defendant 'had strongly recommended sales of [plaintiffs] holdings and purchases of . . . stocks in which [defendant] was dealing as a principal' and the plaintiff relied upon defendant's recommendations of the purchase. (footnotes and citations omitted).<sup>181</sup>

The Court thus distinguished *Affiliated Ute* and *Chasins* and applied the General Reliance Theory.<sup>182</sup> After rejecting *Affiliated Ute*, the Fifth Circuit also tacitly rejected *List*. Since knowledge of the precarious financial position of the company would almost certainly have prevented Simon from buying the stock, the *List* test of causation from a nondisclosure would have been satisfied. The *Simon* court disagrees with this standard as a test of causation. "[S]ome element of general reliance by plaintiff, even in nondisclosure cases, is essential to a Rule 10b-5 action."<sup>183</sup> Thus, the Court rejects the whole notion of reliance on a nondisclosure, limiting recovery to cases of actual reliance on some action, not merely a nondisclosure.

c. *Shapiro v. Merrill Lynch*

In the next major case construing *Affiliated Ute* the Second Circuit reached an opposite result of that of *Simon*. In *Shapiro v. Merrill Lynch*,<sup>184</sup> the defendant brokerage firm obtained adverse inside information from the Douglas Aircraft Company for which it was to underwrite an issue of debentures. The defendant "tipped" this information to some of its institutional customers but did not trade on the basis of the information itself. These customers sold their stock (some even made short sales) on the basis of the "tip." Plaintiff, without any knowledge of defendant's activities, bought stock during the time the "tippees" were selling. The Second Circuit, in denying defendant's motion for judgement on the pleadings, held that the defendant had a duty to the plaintiff to disclose the information and that the necessary causal connection between the defendant's conduct and the plaintiff's harm was established.

The Court began by dividing its analysis into two parts: first, was there a violation of Rule 10b-5, and, second, if so, should the defendants be liable to the plaintiffs for damages? Considering the violation

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181. *Id.* at 884-85 (footnotes and citations omitted).

182. The *Simon* case represents only part of the General Reliance Theory, the negative half. That is, the court holds that no reliance on an omission exists in the absence of general reliance. *Simon* says nothing about establishing causation from proof of general reliance. *Chasins* and *Mills* are needed for that, the positive half of the theory. See note 124 *supra*.

183. 482 F.2d at 884.

184. 495 F.2d 228 (2d Cir. 1974).



question in the light of its earlier decision in *SEC v. Texas Gulf Sulphur*, the Court quoted, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . ., must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."<sup>185</sup>

Thus disposed to find a violation, the Court turned to the defendant's argument that *Texas Gulf Sulphur* was inapplicable because it was an SEC injunction action, not a suit for private damages. The Court found that the same policy applied in this case. It concluded,

[d]efendant's owed a duty—for the breach of which they may be held liable in this private action for damages—not only to the purchasers of the actual shares sold by defendant . . . but to all persons who during the same period purchased Douglas stock on the open market without knowledge of the material inside information which was in the possession of defendants.<sup>186</sup>

Having thus found a violation of Rule 10b-5, the Court addressed the remaining question of whether the defendant should be liable to the plaintiff for damages. As is clear in the analysis of the duty question, the Court felt that there should be liability. All that remained to be shown was causation.

The defendants argued along the lines of the General Reliance Theory that

it was Douglas' precarious financial condition, not defendant's securities law violations, which precipitated the sudden, substantial drop in the market price of Douglas stock and hence the losses sustained by plaintiffs; that, since plaintiffs had no prior or contemporaneous knowledge of defendant's actions, they would have purchased Douglas stock regardless of defendant's securities law violations, and that, since defendant's sales were unrelated to plaintiff's purchases and all transactions took place on anonymous public stock exchanges, there is lacking the requisite connection between defendant's alleged violations and the alleged losses sustained by plaintiffs.<sup>187</sup>

The Court rejected this argument, stating briefly that on the authority of *Affiliated Ute*, "the requisite element of causation in fact has been established by the uncontroverted facts that defendants traded in or recommended trading in Douglas stock without disclosing material inside information which plaintiffs as reasonable investors might have considered important in making their decision to purchase Douglas

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185. *Id.* at 236, citing *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (1968).

186. *Id.* at 237.

187. *Id.* at 238.

stock.”<sup>188</sup>

“Backing up a bit” from its *Affiliated Ute* conclusion the Court reviewed the pre-*Affiliated Ute* law and decided that the same end point is reached.

[T]he proper test to determine whether causation in fact has been established in a non-disclosure case is ‘whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact’ *List . . .*, *Chasins . . .*

[T]he Rule 10b-5 causation in fact requirement is satisfied by plaintiff’s allegation that they would not have purchased Douglas stock if they had known of the information withheld by defendants.<sup>189</sup>

The Court then returned to *Affiliated Ute* and emphasized that it controlled in this case. It held that, under the *Affiliated Ute* case, “the requisite elements of causation in fact has been established by the admitted withholding of defendants of material inside information which they were under an obligation to disclose, such information being clearly material . . . .”<sup>190</sup> The Court then rejected the defendant’s General Reliance argument, holding that *Affiliated Ute* should not be restricted to its facts “which involved face-to-face transactions.”<sup>191</sup> Instead, the Court held that the *Affiliated Ute* rule was not dependent upon the relationship of the parties, but rather “upon whether the defendant is obligated to disclose the inside information.”<sup>192</sup>

A synopsis of the Court’s reasoning is that (a) there was a duty to disclose in these circumstances, (b) since the plaintiff’s pleadings must be accepted as true and the plaintiff claimed causation in fact under the *List* standard, causation in fact is established under pre-*Affiliated Ute* law, and (c) there is no need to refer to prior law since under *Affiliated Ute* the duty to disclose and the withholding of a material fact establish causation in fact. The Court thus interprets *Affiliated Ute* in accord with the Implied Reliance Theory, that somehow a duty to disclose and the withholding of a material fact “establish” causation in fact. In applying the Implied Reliance Theory, the *Shapiro* court is constrained only to follow the nonsensical “duty” language of *Affiliated Ute*, as a part of the causation issue.

The Second Circuit properly determined that there was a duty to disclose, such that nondisclosure would justify holding the defendants liable for plaintiff’s damages. Though its conclusion may be debated,

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188. *Id.*

189. *Id.* at 239-40.

190. *Id.* at 240.

191. *Id.* The General Reliance Theory presumption is, of course, not limited to face-to-face transactions, but to ones where general reliance is present.

192. *Id.*

its analysis is proper under either the Implied Reliance or General Reliance Theory. The Court then turns to the issue of causation. The *List* test is clearly satisfied, as the plaintiff merely pleaded causation in fact under it. The Court, however, was not satisfied with this simple disposal of the issue. The impression from the opinion is that the Court was somewhat hesitant to rely on the *List* test in the open market setting. As discussed above,<sup>193</sup> though the *List* test is logically independent of the relationship between the parties, its application in cases not involving a context of personal dealings results in practically everyone in the whole world being a cause in fact of the harm.

So, perhaps to justify causation in the open market setting, the Court relied on the *Affiliated Ute* decision for its holding.<sup>194</sup> Under the Implied Reliance Theory all that is needed is a finding of a material omission. The question of *duty* under this theory is irrelevant to a finding of causation in fact, as, of course, it must be. However, the *Shapiro* court, perhaps only to meet the literal language of the *Affiliated Ute* standard, clearly indicated that "duty" was an integral part of its causation analysis. Aside from this flaw, the *Shapiro* decision was a correct application of the Implied Reliance Theory.

The General Reliance Theory would have led to a much different result in *Shapiro*. There was no "general reliance" in the *Shapiro* case. Under the General Reliance Theory, *Affiliated Ute* is inapplicable. The Court then might have turned to *List*, the pre-*Affiliated Ute* standard of causation. *Shapiro* then would have been the real test of the *List* standard. If *List* were applied, as it logically might have been, the causation in fact standard would have been so broad as to be no limitation at all. However, the focus then would have been on duty in the impersonal setting, which is probably the correct question to decide liability in this situation.<sup>195</sup> The true General Reliance Theory, as exemplified in *Simon*, would reject the *List* test after rejecting the application of *Affiliated Ute*. Since there was no general reliance by plaintiff there was no causation in fact. A broader analysis of the problem of causation in the open market context is given below.

*d. Fridrich v. Bradford*

The *Shapiro* analysis was sharply criticized by the Sixth Circuit in *Fridrich v. Bradford* in 1976.<sup>196</sup> Applying the General Reliance Theory,

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193. See text accompanying notes 121-123 *supra*.

194. Of course, if this was the reason for the Court's reliance on *Ute*, it was mistaken. The Implied Reliance Theory is dependent on the *List* test to justify the presumption. See text accompanying notes 139-143 *supra*.

195. See text accompanying notes 227-230 *infra*.

196. 542 F.2d 307 (6th Cir.), *cert. denied*, 429 U.S. 1053 (1977).

the *Fridrich* Court held that *Affiliated Ute* was applicable in the open market setting. The Court found that there was no causation in trading on inside information in the impersonal market since the market traders' actions were not influenced by the insiders trading.

The Court reasoned that, since the "disclose or abstain" rule of *Texas Gulf Sulphur* allows an insider not to disclose information,

[i]nvestors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendant's trading did not alter plaintiff's expectations when they sold their stock, and in no way influenced plaintiff's trading decision . . . [T]herefore the defendant's act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of insiders.<sup>197</sup>

The Court then turned to *Affiliated Ute*. Plainly endorsing the General Reliance Theory, Judge Engel wrote:

We are unable to construe the language [relied on by the Second Circuit in *Shapiro*] . . . so broadly. It was shown in *Affiliated Ute* that the defendant bank employees had engaged in prior business dealings with the plaintiff Indians. [footnote: It seems clear that because of their prior business dealings with plaintiffs, defendants in *Affiliated Ute* owed a duty of disclosure to them . . . ] They entered into a deliberate scheme to induce the plaintiffs to sell their stock without disclosure of material facts which would have influenced the decision to sell. The resulting sales were a direct result of the scheme. Thus, it comes as no surprise that the Supreme Court concluded that "[U]nder the circumstances of this case, . . ., all that was necessary was that the information withheld be material in order to establish the requisite causation."<sup>198</sup>

The Court justified this reading of *Affiliated Ute* by noting its reference to *Chasins*, in the same way in which the General Reliance Theory was developed.<sup>199</sup> Judge Engel concluded:

Here, unlike *Affiliated Ute*, defendants did not perpetrate any scheme to induce defendants to sell their stock. Plaintiffs and defendants here had no relationship whatever during the period in question. The plaintiffs in *Affiliated Ute* had a right to expect that the defendant bank officials would fully disclose all material information concerning the stock while inducing them to sell. When defendants did not make full disclosure, they breached Rule 10b-5 and became liable for plaintiff's foreseeable damages. The type of relationship ex-

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197. *Id.* at 318-19 (footnotes omitted).

198. *Id.* at 319.

199. *Id.*

isting between plaintiffs and defendants is totally absent here.<sup>200</sup>

The *Fridrich* opinion gives both a clear explanation of the General Reliance Theory and a correct application of it. By looking at the basis of the *Affiliated Ute* decision the Court is able to understand its limits, in contrast to the *Shapiro* court, which only reads the *Affiliated Ute* conclusion mechanically.

The *Fridrich* court, however, like *Simon*, failed to mention the *List* causation standard once *Affiliated Ute* was rejected as irrelevant. It is crystal clear that the nondisclosures in *Fridrich* meet the *List* standard—if the plaintiff had had the information disclosed to him he would have acted differently. Thus, the Court might have discussed the reach of the *List* decision. Instead, *List* is not even mentioned. The court merely holds that the defendant's actions (as opposed to his nondisclosures) did not cause the plaintiffs to enter into the transaction. This is tantamount to holding that nondisclosures are not actionable in any *impersonal* situation. The tension between *List* and *Shapiro* and the General Reliance Theory is addressed more fully below, in the discussion of the open market.

##### 5. *The Affiliated Ute Presumption in the Lower Courts*

The *Affiliated Ute* holding leaves open two questions<sup>201</sup> which have been the subject of much controversy: (1) Is the presumption to be limited to cases of omissions? and (2) Is the presumption rebuttable? The lower courts are in substantial agreement that the presumption should not apply to misrepresentations, and that, when it applies, it should be rebuttable. Before addressing those questions, a review of the purposes of the presumption under the two theories is in order. The Implied Reliance Theory understands *Affiliated Ute's* purpose in applying the presumption as one to both help alleviate the plaintiff's difficult burden in proving reliance on an omission and to avoid problems inherent in the dubious value of such proof.<sup>202</sup> The General Reliance Theory contains these purposes but also recognizes another, a sort of punishment-deterrent motive in the nondisclosure situation.<sup>203</sup>

###### *a. Should the Presumption Apply Only to the Case of Nondisclosures?*

An analysis of the presumption leads to the conclusion, that, under

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200. *Id.* at 320.

201. The presumption has also been used to facilitate class actions by replacing the individual reliance requirement with the "common question" of materiality. See *Cameron v. Adams & Co.*, 547 F.2d 473, 476 (9th Cir. 1976). This questionable use of *Ute* is beyond the scope of this article.

202. See text accompanying notes 139-142 *supra*.

203. See text accompanying notes 136-138 *supra*.

the Implied Reliance Theory, it should be confined to nondisclosures; affirmative misrepresentations and half truths should not be affected by the *Affiliated Ute* doctrine. The General Reliance Theory does not require this result, but it is not inconsistent with it. The lower courts have, for the most part, adopted this view of *Affiliated Ute*.

In the case of an affirmative misrepresentation, there is no special difficulty in proving reliance. The plaintiff avers that he relied, the defendant denies it and the factfinder decides. This seems to work well in common law fraud cases and there seems to be no reason to change it here. Indeed, the Supreme Court in *Affiliated Ute* indicated that the presumption should not apply to misrepresentations. "Under the circumstances of this case, *involving primarily a failure to disclose*, positive proof of reliance is not a prerequisite to recovery."<sup>204</sup>

A more difficult problem is presented by the case of the half truth. A half truth may be defined as a statement that is true by itself, but which has misleading implications if certain facts are not disclosed.<sup>205</sup> To prove reliance on a half truth the plaintiff cannot merely show that he believed the statements actually made. Those are presumably true. He really must show that he acted on the belief that the nondisclosed facts were not true. However, this does *not* present the same proof problems as in the nondisclosure case.

Since the original statements were misleading because of the omissions, the nonexistence of the omitted facts can be reasonably assumed from the statements. Thus, the half truth is very much like a statement to the effect that the true part is true and that the reasonable assumptions following from it are true. The plaintiff can claim he believed the original statement to be true and thus believed the assumptions to be true.<sup>206</sup> Thus, just as in the case of an actual misrepresentation, the plaintiff can show he *believed* something and acted on that belief. The factfinder then has no theoretical problems in deciding whether or not there was reliance.

The difference between this case and that of a nondisclosure is that the plaintiff in the half truth case has a basis (the half truth) for forming a belief in the nonexistence of the omitted facts. Thus, he can plead he *believed* in their nonexistence. In other words he can plead he believed in the half truth—not in the restrictive way in which it is true, but in the literal way to be expected in its context, in which by definition it is false. Plaintiff needs no special help to prove this. Thus, under the Implied Reliance Theory, no presumption should apply.

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204. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) (emphasis added).

205. RESTATEMENT, *supra* note 16, at §551(2)(a).

206. This is the situation in common law fraud. See note 27 *supra*.

In contrast, in the case of the nondisclosure, the plaintiff normally has no basis for a belief in the nonexistence of the nondisclosed facts. Normally, the nondisclosure would be of such a nature that he never thought about it. Then he has the problem of demonstrating he would have relied on a hypothetical statement that the omitted facts were true. This is the case where a presumption makes sense under the Implied Causation Theory.

The answer to the scope question under the General Reliance Theory is not so clear. The *Chasins*, *Mills* and *Affiliated Ute* cases which form the basis of the theory all involved nondisclosures. These cases do not indicate whether they should be extended to cover the misrepresentation and half truth cases. On one hand, the argument above, that the common law was able to deal with a reliance requirement, indicates no need for a special standard. However, the justification for the General Reliance Theory is different from the Implied Reliance Theory. In addition to difficulties of proof, the General Reliance Theory's justification seems to include that, given general reliance and a violation of the rule, liability furthers the purposes of the rule. Thus, given general reliance, and a misrepresentation or nondisclosure constituting a violation of the rule, the General Reliance Theory may imply liability or at least a shift of the burden of proof to the defendant.

The SEC brief in the *Affiliated Ute* case,<sup>207</sup> and the *Mills* opinion<sup>208</sup> imply that difficulty of proof (or the meaninglessness of it) is an important factor in the implication of reliance in the General Reliance Theory. Thus, difficulty of proof is certainly a positive factor in recommending the presumption. This factor is, of course, missing in the case of misrepresentations and half truths, as discussed above. Since the present law seems to work well in these cases, there is no reason to extend the presumption to misrepresentations and half truths, though such an extension would be consistent with the General Reliance Theory.

A more difficult case than that of half truths is that in which there are mixed misrepresentations and nondisclosures, when there are no half truths. The *Affiliated Ute* opinion seems to imply that the presumption would not apply, unless the nondisclosures so far outweighed the misrepresentations as to be "primarily a failure to disclose."<sup>209</sup> Under both the Implied and General Reliance Theories, however, it seems better to apply the presumption *whenever* there is a nondisclosure.<sup>210</sup>

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207. Brief, *supra* note 167, at 66.

208. *Mills v. Electric Auto Lite Co.*, 396 U.S. 375, 385 (1970).

209. 406 U.S. at 153.

210. The General Reliance Theory, of course, requires proof of general reliance.

As long as the plaintiff claims that he relied on a single nondisclosure, he has the same proof problems, at least as far as that nondisclosure goes, as if only nondisclosures were present. Therefore he should get the benefit of the presumption. After all, he need only show that he relied on one nondisclosure for the defendant to be a cause in fact of his entering into the transaction, regardless of how many misleading statements he believed or did not believe. Additional misleading statements should not increase his proof problems in showing he relied on the nondisclosure.

In accord with this analysis, in most of the circuits plaintiffs must prove reliance in cases involving only misrepresentations.<sup>211</sup> Only the Fourth Circuit has extended the *Affiliated Ute* presumption to misrepresentations.<sup>212</sup>

The half truth issue is not as well settled. The Eighth Circuit in *Vervaecke v. Chiles, Heider & Co., Inc.*,<sup>213</sup> refused to extend the doctrine to half truths. The Ninth Circuit, however, approves of the practice.<sup>214</sup> The case of mixed omissions and misrepresentations has been widely held to be subject to the presumption though not in the Third Circuit.<sup>215</sup>

211. See, e.g., *Vervaecke v. Chiles, Heider & Co., Inc.*, 578 F.2d 713, 717 (8th Cir. 1978); *Rifkin v. Crow*, 574 F.2d 256, 262 (5th Cir. 1978); *Holdsworth v. Strong*, 545 F.2d 687, 695 (10th Cir. 1976); *Chelsea Associates v. Rapanos*, 527 F.2d 1266, 1271 (6th Cir. 1975); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 589-91 (1975). See *Little v. First California Co.*, 532 F.2d 1302, 1304 n.4 (9th Cir. 1976) (categories of omissions and misrepresentations not exclusive). The matter is undecided in the Ninth Circuit, *Keirnan v. Homeland, Inc.*, 611 F.2d 785, (9th Cir. 1980).

212. *Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975).

When a broker misrepresents a material fact, or in the circumstances shown by the plaintiff's evidence in this case, fails to disclose information that the customer would consider significant, it may be inferred that the customer would have relied on the broker's statement or, in the case of nondisclosure, that he would have relied on the information had he known it.

*Id.* at 257, citing *Affiliated Ute*. The court continues enigmatically, "*Affiliated Ute* also teaches that causation can be established by proof of the misrepresentation or nondisclosure." *Id.*; see also *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 399-400 (2d Cir. 1973) (Mansfield, J., concurring and dissenting, construing Rule 14a-9 under *Mills* and *Ute*).

213. 578 F.2d at 717-18.

214. *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975).

The class members' substantive claims either are, or can be, cast in omission or nondisclosure terms—the company's financial reporting failed to disclose the need for reserves, conditions reflecting on the value of the inventory or other facts necessary to make the reported figures not misleading. The Supreme Court has recognized that under such circumstances . . . 'an obligation to disclose, and this withholding of material fact establish[es] requisite element of causation in fact.'

*Id.* at 905, 906.

215. *Sundstrand v. Sun Chemical Corp.*, 553 F.2d 1033, 1048 (7th Cir. 1977); *Cameron v. E.M. Adams & Co.*, 547 F.2d 473, 476-77 (9th Cir. 1976); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975) (alt. holding); *Thomas v. Duralite Co., Inc.*, 524 F.2d 577 (3d Cir. 1975); *Tital Group Inc. v. Fagen*, 513 F.2d 234, 238-39 (2d Cir. 1975); see also, *Mills*, 396 U.S. at 385; *Swanson v. American Consumers Industries, Inc.*, 475 F.2d 516, 519 (7th Cir. 1973) (proxy cases). But see *Huddleston v. Herman E. MacLean*, 640 F.2d 534 (5th Cir. 1981), cert. granted, — U.S. — (1982) in which the *Ute* presumption was not applied to a mixed case of misrepresentations and nondisclosures be-



*b. Is the Presumption Rebuttable?*

The *Affiliated Ute* Court never used the word "presumption." Rather, the literal holding of the opinion is that an "obligation to disclose and . . . withholding of a material fact establish . . . causation in fact."<sup>216</sup> The opinion does not indicate whether the defendant can "rebut" the plaintiff's "proof" of causation in fact through materiality. However, since proof of *causation* is still required under the Implied Reliance Theory, presumably because of the compensatory nature of the Rule 10b-5 private right of action, there seems to be no reason under that theory why the defendant should be liable for the plaintiff's damages if he can show that there was no reliance, hence, no causation in fact. Not only would this produce windfalls for undeserving plaintiffs, but it would also create an unjustified distinction between the causal element required for nondisclosures and misrepresentations. The purpose of the presumption under the Implied Reliance Theory is to help alleviate the plaintiff's difficulty of proof. Rebuttability of the presumption is entirely consistent with this purpose.

Under the General Reliance Theory, these arguments also apply. If the private action under the rule is thought to be compensatory in nature then rebuttability seems to be in order. However, the General Reliance Theory seems to be based at least in part on a deterrent idea. In fact, *Chasins* and *Mills* both indicate that general reliance establishes the requisite causal connection; specific reliance is unnecessary. Therefore, proof of specific "nonreliance" seems irrelevant.<sup>217</sup> However, simple fairness seems to dictate that there should be no liability if a lack of reliance on the specific omission is shown.

Consistent with this analysis, a rebuttability of the presumption has been adopted in all of the circuit courts that have considered the question.<sup>218</sup>

cause the conduct was characterized as half-truths, not omissions *see* note 214 *supra*. In *Sharp v. Cooper E. Lybrand*, 649 F.2d 175 (3d Cir. 1981), a case involving mixed misrepresentations and omissions, the Third Circuit rejected essentially the analysis presented here: "Although this resolution would have great appeal to graduate logicians in a classroom, we can not be persuaded to adopt it for use in a courtroom." 649 F.2d at 188. The court then adopted a flexible approach, "analyz[ing] the plaintiff's allegations, in light of the likely proof at trial, and determin[ing] the most reasonable placement of the burden of proof of reliance." *Id.* at 188.

216. 406 U.S. at 154 (emphasis added).

217. *But see* 480 F.2d at 399-400.

218. *Rifkin v. Crow*, 574 F.2d 256, 262 (5th Cir. 1978); *St. Louis U. Trust Co. v. Merrill Lynch*, 562 F.2d 1040, 1049 (8th Cir. 1977); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1048 (7th Cir. 1977); *Chelsea Associates v. Rapanos*, 527 F.2d 1266, 1271-72 (6th Cir. 1975); *Carras v. Burns*, 526 F.2d 251, 257 (4th Cir. 1975); *Blackie v. Barrack*, 524 F.2d 891, 906-07 (9th Cir. 1975); *Rochez Bros. v. Rhodes*, 491 F.2d 402, 410 (3d Cir. 1973); *Lorber v. Beebe*, 407 F. Supp. 279, 288-89 (S.D.N.Y. 1975); *but see* *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (proxy case); 480 F.2d at 389-400 (proxy case); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV.

### 6. *A Common Error in the Application of Affiliated Ute*

Though the Implied Reliance and the General Reliance Theories normally give the same result in situations involving personal contact, the two theories allocate the burden of proof on the issue of general reliance differently. The Implied Reliance Theory accepts that, in certain cases, the defendant can rebut the *Affiliated Ute* presumption by proof of a lack of reliance. In addition, proof by plaintiff of any reliance is not required. The General Reliance Theory, on the other hand, requires the plaintiff to prove general reliance to satisfy the causation requirement. Since the Implied Reliance Theory<sup>219</sup> is normally used, the burden on the plaintiff which should be required by *Chasins*, *Mills* and *Affiliated Ute* to show general reliance has erroneously not been required.

*Affiliated Ute* did not mention the question of the burden of proof on general reliance. In fact, the opinion does not explicitly require it to be proven. However, general reliance was obvious in that case. In addition, the plaintiff was required to prove general reliance in *Chasins* and *Mills*. The theory of *Affiliated Ute* that is advocated in this article based on the Court's reliance on *Chasins*, the General Reliance Theory, thus requires the plaintiff to prove general reliance before the causation requirement is satisfied. Therefore, any court that applies *Affiliated Ute* should first require proof of general reliance.

Unfortunately, such is not the case. Most courts ignore the controversy between General and Implied Reliance, except when the issue must be considered, as in cases of clear lack of general reliance like *Shapiro*, *Fridrich* and *Simon*. In ignoring the General Reliance Theory, the courts also ignore the general reliance requirement. These courts do not require general reliance to be proven; instead they apply the *Affiliated Ute* "presumption" under the Implied Reliance Theory.<sup>220</sup> Then, if defendant can prove a lack of reliance, the courts hold that the presumption has been rebutted.<sup>221</sup> This places the burden of proof on the defendant, when it should be on the plaintiff.

This shift of the burden of proof reflects a fundamental error in the courts' analysis of the *Affiliated Ute* decision. Since the holding of *Affiliated Ute* mentions no general reliance requirement, the courts imagine that materiality suffices to establish the requisite causal connection. According to the analysis above, this is incorrect. *Affiliated Ute* does

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584, 606 (1975); Note, *The Nature and Scope of the Reliance Requirement under SEC Rule 10b-5*, 24 CASE W. RESERVE L. REV. 363, 388 (1973).

219. See note 172 *supra*.

220. See note 153 *supra*.

221. See note 218 *supra*.

not stand for the proposition that materiality presumes causation. Instead, *Affiliated Ute*'s holding is in accord with *Chasins* and *Mills*, to wit, given materiality (a violation of the rule), general reliance establishes causation. Thus, even if such reliance is obvious (as it probably normally is), the burden of proof should be with the plaintiff to establish at least general reliance.

### 7. *Fraud on the Market*—*Blackie v. Barrack*

The Ninth Circuit has used the *List* standard for "reliance" on omissions and the ideas of the Implied Reliance Theory in *Blackie v. Barrack*<sup>222</sup> to perform the seemingly impossible task of implying market traders "reliance" from material misrepresentations made by a stock issuer to the public, even though the traders may have been unaware of the misrepresentations. Though it may be difficult to understand how one can rely on, i.e., believe in and act upon that belief in, misrepresentations that one has no knowledge of, the Ninth Circuit "showed" that not only is it possible to prove reliance but that reliance can be implied by the materiality of the misrepresentations. In so doing, the Ninth Circuit demonstrated the meaninglessness of the application of the *List* standard in cases not involving general reliance and further diminished the role of the causation requirement in Rule 10b-5 actions. Instead of contorting the concept of causation in private actions under Rule 10b-5 to arrive at the desired result, the court more properly should have addressed the policy issues involved directly and made its decision based on that analysis.

The *Blackie* case was an appeal from a lower court grant of class certification in a class action under Rule 10b-5.<sup>223</sup> The plaintiff class alleged that the defendant corporation<sup>224</sup> misrepresented its financial statements over a twenty-seven month period by delaying disclosure of large losses it had suffered. The plaintiff class consisted of all persons who purchased securities of the defendant corporation during the period of the misrepresentations, whether or not they were aware of the misrepresentations. The Ninth Circuit held that causation was no bar to the class action because the Rule 10b-5 causal requirement was satisfied by the materiality of the misrepresentations combined with plaintiff's market purchases.<sup>225</sup>

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222. 524 F.2d 891 (9th Cir. 1975).

223. See note 201 *supra*, for the application of the *Affiliated Ute* presumption in class actions.

224. The corporation's officers and independent auditors were also defendants.

225. The Ninth Circuit gives no reasons for its unprecedented choice of the applicable causal standard. It is clear, however, that the court did apply the *List* standard: "[T]he causal chain is broken only if purchaser would have purchased the stock even had he known of the misrepresentation; [i]n this context we think proof of reliance means at most a requirement that plaintiff

Though the opinion is sometimes difficult to follow, the most reasonable synopsis of the court's reasoning seems to be that in this situation, (1) transaction causation is demonstrated if plaintiffs can show that they would not have traded had they known that the misrepresentations were untrue,<sup>226</sup> that is, if the *List* test for reliance on an *omission* applies, (2) the materiality of the misrepresentations circumstantially establishes that some traders relied on them, (3) that reliance inflated the price of the stock, (4) because most traders would assume that the price of the stock was inflated by the effect of the misrepresentations, if they had known of such misrepresentations, they would not have purchased the stock, (5) because it is desirable for traders to be able to "rely" on the fair setting of the price of stock in public markets, (6) because plaintiffs did rely generally on this fair setting, and (7) furthermore because under *Affiliated Ute* and *Mills*, materiality is so close to reliance and the distance from reliance to materiality is reduced by (4), material misrepresentations and plaintiff's open market purchases suffice to show reliance.

For some unexplained reason the court uses the *List* standard for reliance on omissions for transaction causation in the market situation. The court is, in essence, treating the misrepresentations as if they had been omissions or nondisclosures.<sup>227</sup> Since plaintiff has no special problems in showing actual reliance on, that is, belief in and action on that belief in the misrepresentations, there is no justification for the court's use of the *List* standard.<sup>228</sup> This use of the standard results, of course, in a vast expansion in the number of possible plaintiffs. Instead of being limited to those who were aware of the misrepresentations and who could show actual reliance, the class consists of all who could show they would have acted differently had they known the misrepresented facts were false, even though they may have been unaware of the misrepresentations.<sup>229</sup> Indeed, the Ninth Circuit has gone even further than the *List* standard, holding that the transaction causation standard is met if plaintiffs can show they would have acted differently had they known not only that the omitted facts were true but also that such

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prove directly that he would have acted differently had he known the true facts." 524 F.2d at 908. The court does say that the misrepresentations involved in the case could be "cast in omission or nondisclosure terms—the company's financial reporting failed to disclose the need for reserves, conditions reflecting on the value of the inventory, or other facts necessary to make the reported figures not misleading," *id.* at 905, which conclusion would lead to use of the *List* standard. However, there is no apparent connection between the court's seemingly offhand remark about recasting misrepresentations as omissions and its use of the *List* standard.

226. See note 225 *supra*.

227. See text accompanying note 204.

228. See text accompanying notes 119-128, *supra*.

229. See note 225 *supra*.

facts had been misrepresented to the public.<sup>230</sup>

Not only has the class of possible plaintiffs been greatly enlarged through the use of the *List* standard, a finding of defendant's liability has become much more likely. The *List* causal standard is not difficult to meet. Material misrepresentations almost by definition affect the market price of a stock, as the Ninth Circuit points out.<sup>231</sup> If only an unreasonable trader would not have acted differently had he known a material, omitted fact, then only an utter fool would not have acted differently had he known that a detrimental material fact had been misrepresented to the market. Once this point in the opinion is reached, a so-called *Affiliated Ute-Mills* presumption of reliance from materiality might as well be made, especially in the context of a class action. Enough of those plaintiffs were probably not fools, so that the burden of proof of nonreliance belongs rightfully on defendant.<sup>232</sup>

The Ninth Circuit broke with precedent dramatically in reaching this result. Since plaintiff can show actual reliance on misrepresentations, courts almost uniformly require such proof. Using the *List* standard in cases involving misrepresentations is to abandon the necessity of belief and action on that belief in favor of reliance on events that did not occur and unjustifiably expands the class of possible plaintiffs. Perhaps the most compelling argument against the "causal standard" exposed by the Ninth Circuit in *Blackie* is the simple observation that the court found the requirement of transaction causation satisfied in a situation in which it was absolutely clear that plaintiffs had no knowledge of the misrepresentations, could not have believed in them and, hence, could not have relied on them.

The ideas of the *Blackie* opinion are more defensible in situations involving true omissions to the market rather than misrepresentations. As applied to such a case the reasoning of *Blackie* would be similar to that of *Shapiro*. Under the Implied Reliance Theory, as exemplified by *Shapiro* in a case involving omissions, the *List* standard of reliance would be used as a matter of course. The transaction causation re-

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230. 524 F.2d at 907-08.

231. If the basis of the court's use of the *List* standard is that defendant's misrepresentations can be cast in terms of omissions or non-disclosures, see note 225 *supra*, then the criticism still applies. Casting misrepresentations as omissions results in the same unjustified expansion of the plaintiff class from those who had knowledge of the misrepresentations to all those who would have acted differently had they known the true facts.

Since plaintiff has no special problems in showing actual reliance on misrepresentations, such a recasting of the misrepresentations as omissions with the subsequent unjustified increase in both the size of the class of possible plaintiffs and the likelihood of a finding of causation seems unreasonable.

232. The *Blackie* court argued that trader's "generally rely" on the fair setting of the market price of the stock. 524 F.2d at 907. However, this "general reliance" bears no relation to the "general reliance" involved in personal dealings required for the General Reliance Theory.

quirement might well be satisfied then by proof of defendant's material nondisclosures in connection with plaintiff's open market purchases. Of course, under the General Reliance Theory no "general reliance" would be present in such a case,<sup>233</sup> the *List* standard would not apply and no reliance could be found.

Analysis of the *Blackie* opinion emphasizes the meaninglessness of deciding causation under the *List* standard, except in situations involving personal dealings and general reliance. Given materiality, application of the *List* standard of reliance on an omission practically guarantees a finding of liability. The proper focus of inquiry in cases involving omissions on the open market should not be causation at all, but policy. Decisions dependent on the hypothetical *List* standard mean little in terms of the compensatory rationale of the causation requirement. Moreover, decisions dependent on causation are "all or nothing" in the open market context—either the defendant suffers "Draconian" liabilities or none at all. As is the conclusion below,<sup>234</sup> what is needed is a direct public, noncausation, determination of liability in the market context.<sup>235</sup>

#### 8. Causation and the Open Market

Most cases dealing with causation and the open market analyze the problems in terms of whether *Affiliated Ute* should apply or not. However, the *Affiliated Ute* presumption is merely a convenience of proof. The real issue in the open market setting is not whether *Affiliated Ute* applies, but whether causation can be established or not. Under the *List* standard for reliance on an omission, causation can be established; under the *Fridrich-Simon* general reliance requirement it cannot be. The problem stems from the difficulty in defining "reliance on an omission." This problem will remain undecided and undecidable until the causation question, which is ill-defined and even meaningless in this situation, is replaced by the real issue; whether public policy should impose a duty to disclose in the open market situation such that nondisclosure should lead to liability.

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233. See note 232 *supra*.

234. See text at pages 1064-65 *infra*.

235. The Fifth Circuit recently decided a case somewhat similar to *Blackie*. *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), involved misrepresentations and omissions in defendant's offering circular used in the initial offering of municipal bonds to the public. Plaintiff did not read the offering circular. However, in an opinion remarkable for its lack of understanding of reliance and causation in Rule 10b-5 law the court held that the Rule 10b-5 requirement of transaction causation was satisfied by proof that "defendants knowingly conspired to bring securities into the market which were not entitled to be marketed, intending to defraud purchasers" and that plaintiff "reasonably relied on the [b]onds' availability on the market as an indication of their apparent genuineness and . . . as a result of the scheme to defraud. [Plaintiff] suffered a loss." The dissent in *Shores* adequately points out the deficiencies in the opinion.

The threshold question in approaching a causation on the market issue under present law is whether the *Affiliated Ute* "presumption" applies. The two basic theories of *Affiliated Ute* give disparate results. The General Reliance Theory, approved here as the most accurate theory of *Affiliated Ute*, soundly dismisses the idea of an *Affiliated Ute* presumption here. In fact, the impersonal open market is the antithesis of the normal General Reliance situation. Thus, the two major General Reliance Theory cases, *Fridrich* and *Simon*, clearly indicate that no *Affiliated Ute* presumption should apply in the open market context.<sup>236</sup> On the other hand, the Implied Reliance Theory, the theory of *Affiliated Ute* which has been widely accepted, implies the *Affiliated Ute* presumption regardless of the relationship between the parties. Therefore, the Second Circuit in *Shapiro*<sup>237</sup> found causation in the open market context.

The heart of this difference in analysis, however, is not the application of *Affiliated Ute*. The *Affiliated Ute* presumption is a mere convenience in proof for the plaintiff. The real difference in *Shapiro* and *Fridrich-Simon* is whether there can be causation in an impersonal setting. *Shapiro* holds that there can be, really basing its opinion on *List v. Fashion Park*.<sup>238</sup> *Fridrich* and *Simon* base their rejection of such causation by requiring general reliance as a prerequisite to causation.<sup>239</sup>

The Implied Reliance Theory is based on the closeness of materiality to the *List* standard of reliance on an omission. Since the *List* standard is, by its terms (though not by the case itself) independent of the relationship between the parties, the Implied Reliance Theory is also thought to be independent. Thus, the application of *Affiliated Ute* to an impersonal situation is based on the assumption that *List* is applicable.

On the other hand, the General Reliance Theory of *Affiliated Ute* requires general reliance before *Affiliated Ute* applies. Thus, this theory implies that *Affiliated Ute* is not applicable to impersonal situations. *Fridrich* and *Simon* go beyond this rejection of *Affiliated Ute* and require general reliance before any causation by an omission can be proved. Thus, the real difference between *Shapiro* and *Fridrich-Simon* is whether *List* is applicable to the impersonal situation or whether some general reliance is to be required first.

The *List* theory of causation by nondisclosure states that a nondis-

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236. *Simon*, however, was not an open market case.

237. The Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891 (1975) (alternative holding) makes a similar holding.

238. To imply reliance from materiality of a nondisclosure, the *List* standard must be used. See text accompanying notes 139-142 *supra*.

239. This is only the negative part of the General Reliance Theory. See notes 124 and 181, *supra*.

closure “causes” an event, if some other result would have occurred if the nondisclosed facts had been disclosed. The *Fridrich* and *Simon* cases, on the other hand, reject the idea that a “nonevent” could “cause” anything, requiring proof of causation by the actual conduct of the defendant. These different views lead to opposite results in the open market situation. Any nondisclosed material fact can probably be shown to have “caused” a transaction under the *List* standard in the open market situation. However, without any personal contact or flow of information, no nondisclosure is a “cause” under *Fridrich-Simon*.

The difference between these two theories is really one of the basic definitions of reliance (or causation) on a nondisclosure. The *List* test is essentially a “but for” test, i.e., if “no nondisclosure” then a different result would occur, interpreting “no nondisclosure” as “disclosure to the plaintiff.” The General Reliance test is essentially a reliance or belief test—was the plaintiff relying on the defendant’s conduct? This of course also reduces to a “but for” test, but one of different focus—was the defendant’s conduct a “but for” cause of the plaintiffs entering into the transaction?

The difficulty in deciding between the two theories arises because they both have strong roots in the case of causation by a misrepresentation. In the case of a misrepresentation, the two tests not only give the same results, *they are identical* upon the assumption that in the case of misrepresentation, the misrepresentation itself is the “conduct” scrutinized in the theory. Both tests, therefore, are “but for” tests on the “event” of the misrepresentation. They appear to be different because they focus on slightly different phrasings of the reliance question. The General Reliance Theory asks—did plaintiff rely on the misrepresentation? That is, did the plaintiff rely on the defendant? The *List* test asks—would plaintiff have acted differently if he had known of the misrepresentation?

The problems arise when these questions are translated to the case of a nondisclosure. The *List* test translates easily: would plaintiff have acted differently if he had known the true facts? The General Reliance Theory is not so easy: did plaintiff rely on the omission? This question is interpreted as “did the plaintiff rely on the defendant?”; a requirement of general reliance on the defendant’s activities.

The difficulty in choosing between these two standards demonstrates an important point: *Causation in fact is a fact.*<sup>240</sup> Only events cause other events. Nondisclosures like all events that did not happen, cause nothing, cannot cause anything. When one speaks of nondisclosures

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240. PROSSER, *supra* note 1, §41, at 237.



and causation, one is just taking the factual theory of causation on an event and applying it to nonevents. However, causation by a nonevent is just a myth. It is a myth paid homage to for purposes of public policy, but it is a myth nonetheless.

Causation, including causation by a nonevent, is used as a convenient way to eliminate certain plaintiffs and certain defendants from consideration. In the case of actual events there is some inherent "justice" in this. In the case of nonevents the idea of causation is only one of public policy, to a much greater extent than that of misrepresentations in which causation is a fact.

Since public policy gives no clear causation standard, in the open market situation, the policy questions should be addressed directly in determining liability, instead of using an unworkable test, which was designed for convenience in the first place. The correctness of this conclusion is demonstrated by the vast difference between the effects of the two tests for causation. The General Reliance Theory leaves the defendant scot-free for actions clearly contrary to public policy. The Implied Reliance Theory imposes "Draconian" liabilities, holding defendant liable for all losses by anyone who traded in the stock while the information was undisclosed. It is obvious from these results that causation is not the correct focus for inquiry in this situation. This conclusion was seen clearly by the drafters of the Federal Securities Code.<sup>241</sup> Ignoring the causation issue in the open market situation, they create a remedy on policy grounds, holding the defendant liable to all losing traders in the time period, but only to the extent of his own gains.<sup>242</sup>

Some solution like that of the Code is sensible. Continuing to phrase a policy issue in terms of causation can only lead to confusion and injustice.<sup>243</sup>

### C. *Reliance and Causation under the Federal Securities Code*

The ALI Federal Securities Code<sup>244</sup> proposes a new approach to-

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241. See note 244 *infra*.

242. FED. SEC. CODE §§1703(b) (liability), 1708(b) (measure of damages) (Proposed Official Draft 1978). Section 1708(b)(3) states that the measure . . . [of damages] is limited as if all the plaintiffs, together with all the members of the class in the cause of a class action, had bought (or sold) only the amount of securities that the defendant had sold (or bought) . . . .

243. This discussion is equally applicable to the change in the definition of causation by the Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891 (1975).

244. See generally FED. SEC. CODE (Proposed Official Draft 1978). The concept of a coherent codification of the various federal securities laws arose with the Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association. See generally, Hershman, *An Overview-Regulation of Securities and the Securities Markets: A Timely Report to the Bar*, 78 BUS. LAW. 375 (1973). The American Law Institute, accepting the

wards causation in the Rule 10b-5 situation. Under the Code, no transaction causation need be shown to establish liability for fraud in market transactions,<sup>245</sup> for defendant's fraudulent purchase from or sales to the plaintiff,<sup>246</sup> for market manipulation (except to non-traders),<sup>247</sup> for false filings,<sup>248</sup> or for churning.<sup>249</sup> In certain other situations,<sup>250</sup> the Code adopts the present causation requirement. Thus, the Code follows the current trend in the law towards a weakened causal connection between the defendant's conduct and the plaintiff's entrance into the transaction.

The basic code section on civil liability for violation of a 10b-5 type action is Section 1703. Subsections 1703(a) and (b) address the common Rule 10b-5 situation:

Sales and Purchases by Fraud or Misrepresentation Sec. 1703(a)  
Transactions Not Effected in the Markets

If the transaction is not effected in a manner that would make the matching of buyers and sellers substantially fortuitous, a seller or buyer who violates Sections 1062(a)(1) [misrepresentation or fraudulent act], 1602(b)(1)(A) [failure to correct previous misstatement], 1063(a) [inside information], or 1613 [violation of Commission rule] is liable to his buyer or seller for rescission or damages.

(b) Transactions Effected in the Markets—If the transaction is effected in a manner that would make the matching of buyers or sellers substantially fortuitous, a seller or buyer who violates Sections 1062(a)(1), 1062(b)(1)(A), or 1613 is liable for damages to a person who buys or sells during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and undoing at the end of the day when all material facts (or facts of special significance in the case of Section 1603(a)) become generally available.

These subsections apply only to situations in which the defendant deals directly with the plaintiff (i.e., defendant is a buyer or seller and plaintiff is the corresponding seller or buyer) or when the defendant trades on an impersonal exchange. In such a case the Code precludes any question of causation if the defendant commits a fraudulent act (in-

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task, selected Professor Louis Loss of the Harvard Law School as the Reporter for the Code. See, Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

245. FED. SEC. CODE §1703(b) (Proposed Official Draft 1978).

246. *Id.* §1703(a).

247. *Id.* §1710.

248. *Id.* §§1704, 1705, 1706.

249. *Id.* §1717.

250. *Id.* §§1709(a) (fraud in a fiduciary relationship); 1709(c) (fraud by investment advisors); 1710(e) (market manipulation with respect to non-traders); 1715 (unlawful trading procedures); 1721 (violation of rules of self regulatory organizations).

cluding an omission if there is a duty to disclose) or makes a misrepresentation in connection with the purchase or sale or fails to correct a statement which is a misrepresentation at the time of the transaction or has material inside information or violates a rule of the Commission.

In the case of actual direct dealing between the plaintiff and defendant, the defendant is liable for rescission or damages. In the open market case, defendant is liable to all who bought (if he sold) or sold (if he bought) from the date of defendant's first unlawful transaction until the day when the information becomes "generally available."<sup>251</sup> Damages in the open market are the same as in the direct dealing situation. Defendant is liable up to the amount of his profits.<sup>252</sup> The many possible plaintiffs in the open market share *pro rata* in the fund created by the defendant's disgorgement.<sup>253</sup>

However, in the open market case the defendant has a defense if he has "corrected" the misrepresentation or omission.<sup>254</sup> This defense does not apply if the plaintiff bought before the correction or if he justifiably relied "on the misrepresentation or omission."<sup>255</sup> In this case "[r]eliance on an omission may be proved by proof or reliance on the particular filing or document and ignorance of the omission; but reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff read a particular filing document."<sup>256</sup>

The causation requirement is also eliminated in the Code for claims based on misrepresentations or omissions of material facts in filings<sup>257</sup>

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251. *Id.* §1703(b).

252. See note 242 *supra*.

253. FED. SEC. CODE §1711 (Proposed Official Draft 1978).

254. *Id.* §1703(d). Defendant can correct his misrepresentation or omission by "a filing or press release or in any manner reasonably designed to bring the correction to the attention of the investing public . . . ." *Id.*

255. *Id.*

256. *Id.* This comment is nicely understood in terms of the theory developed in the earlier sections of this paper. "Reliance on an omission may be proved by proof of reliance on the particular filing or document and ignorance of the omission . . .," that is, general reliance on the filing or document establishes "reliance" on the omission. This is close to the holding of *Chasins* and *Mills*. It is, of course, half of the General Reliance Theory. "[B]ut reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff need a particular filing or document." The Code thus rejects the restrictive half of the General Reliance Theory, that general reliance is needed to show reliance on an omission. Thus, the ideas of *Simon* and *Fridrich* are rejected.

257. Such a claim may be based on Sections 1704, 1705 or 1706. Section 1704 creates civil liability for misrepresentations and omissions of material fact in an effective registration statement, an effective offering statement or any report filed with the SEC and incorporated by reference in any such filing. An alternative to this section would also include the annual report filed with the SEC, *id.* §1704(e); see *id.* §602. This liability attaches to the registrant, the principal executive officer or officers, the principal financial officer, the principal accounting officer and the directors of the registrant, experts and other persons named with their consent in the document, and underwriters in the case of an offering statement. *Id.* §1704(d). Eligible plaintiffs under Section 1704 are those persons who bought a security in a class covered by the offering statement, the registration statement, or report, after their effectiveness. *Id.* §1704(e). Section 1705 creates civil liability for the registrant for misrepresentations made with scienter in filings with the SEC not

with the SEC, or on public misrepresentations.<sup>258</sup> The defendant in such actions has the defense of correction as in Section 1703(d), discussed above, which can be avoided by the plaintiff by a showing of justifiable reliance.<sup>259</sup> Finally, actions based on churning<sup>260</sup> and market manipulation and stabilization (brought by traders),<sup>261</sup> which by their nature need no proof of transaction causation, have no such requirement under the Code.

The present causal requirement is left intact in the Code in several situations. Thus, violation of a fiduciary duty through a misrepresentation, nondisclosure, or failure to correct makes the fiduciary liable for the damages "caused"<sup>262</sup> to the beneficiary. The same causal standard applies to cases involving market manipulation or stabilization (non-traders), violation of the rules of certain self regulatory organizations, fraud by investment advisors and unlawful trading practices.<sup>263</sup> Reliance will be important where proof of causation is required just as in the present law to establish under Section 303(19)(A) that the conduct was a substantial factor in producing the loss.<sup>264</sup>

The reason for the relaxation of the causation standard in Rule 10b-5 type situations is not explicitly given in the comments. However, since Sections 1703(a) and 1704 of the Code are based on Sections 12(2) and 11(a) respectively,<sup>265</sup> of the Securities Act of 1933,<sup>266</sup> the policies of these provisions would seem to control. Neither of these provisions of the present law calls for proof of transaction causation, presumably because of their deterrent nature.

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covered under Section 1704. Section 1706 applies Section 1704 and Section 1705 in certain situations to secondary distributors and underwriters with respect to distribution statements.

258. Section 1707 creates civil liability for a company making public misrepresentations with scienter to anyone buying thereafter.

259. FED. SEC. CODE §§1704(d), 1705(d), 1707(d) (Proposed Official Draft 1978).

260. *Id.* §171. Churning is defined and forbidden in Section 1606:

It is unlawful for a broker, dealer, municipal broker, or municipal dealer to effect with or for a customer with respect to whose account he or his agent exercises investment discretion, or is in a position to determine the volume and frequency of transactions by reason of the customer's willingness to follow his or his agent's suggestions, transactions that are excessive in volume or frequency in light of the amount of profits or commissions of the broker, dealer, municipal broker, municipal dealer, or his agent in relation to the size of the account, the needs and objectives of the customer as ascertained on reasonable inquiring, and the pattern of trading in the amount.

261. FED. SEC. CODE §202(19) (Proposed Official Draft 1978). "Caused.—A loss is 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct."

262. See note 242 *supra*.

263. FED. SEC. CODE §202(19) comment (5) (Proposed Official Draft 1978).

264. *Id.* §§1703(a) source and comment (1), 1704 source.

265. 15 U.S.C. §771(2) (1976) and *id.* §77k(a) respectively. Section 1703(a) extends coverage of Section 12(2) of the Securities Act of 1933 to plaintiff sellers as well as buyers; see comment (1).

266. FED. SEC. CODE §1705, comment (3), citing 3 Loss, *supra* note 2, at 1750-54; 6 Loss, *supra* note 2, at 3862-63.

The relaxed causation of Section 1705 is explained in a comment to that section: Section 18(a) of the Securities and Exchange Act of 1934 today imposes much too onerous a burden on the plaintiff in requiring him to prove not only reliance but also that he bought or sold "at a price which was affected by" the misstatement, and then limiting him to "damages caused by such reliance." Section 1705's attempt to formulate an action that is reasonably compensatory—or at any rate serves as a reasonable deterrent—and that at the same time is so circumscribed that "the punishment fits the crime."<sup>267</sup>

Section 1710 on market manipulation also requires no proof of transaction causation. There are two ways of considering proof of transaction causation in the market manipulation setting, neither of which would require proof of causation aside from that of manipulation. First, the plaintiff may "rely" on the manipulation in that he is relying on the fairness of the value of the security in question.<sup>268</sup> In that case, proof of manipulation and the plaintiff's transaction suffice to show causation. Second, the manipulation situation can be thought not to involve transaction causation at all—plaintiff is injured merely by trading in the manipulated market. In that view, of course, there is no need for proof of reliance.

Section 1717 on churning also obviously needs no proof of reliance. Reliance on the plaintiff's part is not needed for perpetration of the fraud.

Thus, the reason the Code eliminates the causation requirement of Rule 10b-5 type private actions under Sections 1703(a), 1704, and 1705 is to enhance their deterrent effect. This elimination is justified by the minor expansion of the present law necessary to bring about the inclusion of Rule 10b-5 into these sections. Actions for churning and market manipulation (to traders) simply require no proof of reliance by their natures. Justification for the Code's treatment of open market fraud in Section 1703(b) is discussed below.

Several other powerful reasons exist for the Code's elimination of the causal requirement in certain situations. Both the Implied and General Reliance Theories help to justify this change in the law. In addition, the privity requirement of Section 1703(a) provides an adequate reason for elimination of proof of causation in that case. These are basically two situations covered under Section 1703. The elimination of the

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267. Section 1710 creates civil liability for market manipulation by touting, Section 1609(a), by wash sales and matched orders, Section 1609(b), by trading, Section 1609(c) or by buying during a distribution, Section 1609(d), and for stabilization, defined in Section 1610(a) as violation of an SEC rule while effecting a transaction for the purpose of pegging, fixing, or stabilizing the price of a security of the issuer.

268. This is akin to the *Blackie* "fraud on the market" theory.

causal requirement can be justified by different reasons in each situation. In the direct dealing situation, the deterrent value of punishing a violation of the Code, the probability of "general reliance" given privity, the difficulty of proving reliance on an omission, the probability of reliance where the misstatement or omission is material, and the cost of dealing with the causation issue all might justify elimination of the causal requirement. The same purpose in the market situation is served by the deterrent value of punishing a violation, the difficulties in finding a definition of causation fair to both defendants and plaintiffs, and the Section's restriction of defendants possible liability.

In the direct dealing situation of Section 1703(a), the defendant has profited from a violation of the Code, directly from the plaintiff. The reasons listed above all suggest that no requirement be imposed that the loss to the plaintiff stem directly from specific reliance on the violation itself, since, given privity, there probably was general causation between the defendant's actions and his profit and plaintiff's loss. Though each of the reasons has a different focus, all stem from the feeling, that, given general causation of the loss, a violation of the Act, and profit to the defendant, plaintiff should be compensated.

This "general reliance" is a result of the direct dealings between the parties. Since the defendant bought from or sold securities directly to the plaintiff, the plaintiff, except in very unusual circumstances, probably relied on the defendant not to make misrepresentations or omissions he was obligated to make. The General Reliance Theory then would impose liability on the defendant upon the establishment of a violation of the Code, either presuming (perhaps rebuttably) that reliance on the specific violation occurred or possibly only requiring general causation as the causal standard.

The reasons for this relaxed proof under the General Reliance Theory is that the defendant should "pay" for his violation of the Code (and perhaps be deterred from future violations). This purpose is very strong here, where the defendant has directly profited from the plaintiff's loss. This deterrent purpose and the "unjust enrichment" are theories for liability even without proof of reliance on the specific violation.

The Implied Reliance Theory justifies the same result. Since the violations in Section 1703(a) all involve material facts, the Implied Reliance Theory would (perhaps non-rebuttably) presume reliance. The presumption of course comes from the conclusion that few reasonable men would not rely on material misrepresentations or omissions. Thus, this theory also helps to justify the elimination of the causation standard.

A final justification is the time-honored theme of judicial costs. Proof of non-reliance is difficult and complicated. Given the strong probability of failure, as the Implied Reliance Theory implies, there is good reason to foreclose this theory altogether.

These justifications can be put simply: The defendant acted wrongly, so profiting from the plaintiff, who almost certainly relied. Therefore, plaintiff should recover; proof of non-reliance is expensive and most likely to be unsuccessful, so it will not be required.

Of course, balanced against these rationales is the fear that, inevitably, some plaintiffs whose loss was not caused by the specific violation will recover. In writing a Code, however, difficult choices of this kind must be made and the move to simplicity seems adequately justified, especially in light of present Section 12(2) of the Securities Act of 1933.

The open market situation has been discussed above. In that case, there is a very strong purpose to prevent insider trading. Additionally, causation is meaningless in that situation. Accordingly, the elimination of causation and its replacement with the limitation on defendant's liability is not only justifiable, it is a clear improvement in the present law.

#### CONCLUSION

The difficulty and questionable value of proof of a non-disclosure has led to a relaxation in the causal connection that must be established to succeed in a private action under Rule 10b-5. This "relaxation" was developed in *Chasins* by the Second Circuit, and in *Affiliated Ute*, by the Supreme Court, reflecting a similar change in Rule 14a-9 in the *Mills* case. The new standard is stated simply: Specific reliance or causation by a nondisclosure is not required; only general reliance on the defendant's conduct need be proven.

The common interpretation of the *Affiliated Ute* case, that materiality "presumes" reliance is incorrect. The two views of the case lead to the same result, however, in the normal Rule 10b-5 situation. Even in that case, however, where there is personal contact between the parties, the scope of the application of *Affiliated Ute* is uncertain. The policies behind that case under either theory indicate that the "presumption" should be rebuttable and that it should be confined to cases of omissions and mixed omissions and misrepresentations. In those cases, the theories are not in complete agreement, there is a difference in the allocation of the burden of proof of general reliance under the two views. In the impersonal situation, the interpretation of *Affiliated Ute* advanced in this article agrees with the Sixth Circuit in the *Fridrich* case

that the *Affiliated Ute* case is inapplicable. Thus, the Second Circuit's opinion in *Shapiro* is rejected as an application of *Affiliated Ute*.

The true conflict between *Shapiro* and *Fridrich*, however, is not in the use of the *Affiliated Ute* opinion, but in the definition of reliance on an omission. *Shapiro* uses the characterization of reliance as causation in fact and thus applies a "but for" test in accord with *List*: The omission caused the plaintiff to enter into the transaction if he would not have done so had there been disclosure of the omitted facts. *Fridrich*, on the other hand, focuses on reliance as belief or dependence: the omission caused the plaintiff to enter into the transaction only if he was already relying on the defendant's conduct. Both of the definitions embody certain of the ideas of the concept of reliance on an omission. Neither is clearly correct in the nondisclosure situation. Since neither of the definitions of reliance is plainly correct the focus of the inquiry should not be on a difficult to define causal notion, but on policy directly. This conclusion applies as well to the Ninth Circuit's extension of the causation definition to include "indirect reliance" in the "fraud on the market" theory. Such a policy solution to the impersonal market situation is presented by the ALI Federal Securities Code. The Code requires no proof of causation. Instead it imposes liability on all defendants trading in the market. The harshness of this result is alleviated by strict limitations placed on the extent of the defendants' total liability.

The Code also eliminates the causation requirement in several other situations now actionable under Rule 10b-5. This relaxation of the old element of common law fraud is justified by the deterrent effect of the provisions. In addition, the ideas developed in the cases, reducing the requisite causal connection under Rule 10b-5, help to justify the elimination of the causation requirement in those cases.



