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Causation, Courts, and Congress: A Study of Contradiction in the Federal Securities Laws

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CAUSATION, COURTS, AND CONGRESS: A STUDY OF CONTRADICTION IN THE FEDERAL SECURITIES LAWS†

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I. INTRODUCTION.....	1028
II. THEORIES AND ROLES OF CAUSATION	1032
A. <i>Theories of Causation</i>	1032
1. Cause-in-Fact or "But For" Causation.....	1032
2. Cause-in-Law or Proximate Cause	1035
3. Special Judicial Applications of Cause in Actions for Fraud	1037
4. The Distinction Reconsidered	1039
a. <i>Cause as a Means to Other Ends</i>	1039
b. <i>Other Factors</i>	1041
5. The Strict Economic Approach	1043
6. Summary of Theories of Causation	1045
B. <i>Roles of Causation in Regulatory Schemes and in Private Rights of Action Based on Those Schemes</i>	1046
III. PRIVATE RIGHTS OF ACTION FOR MISREPRESENTATION OR OMISSION UNDER THE FEDERAL SECURITIES LAW.....	1050
A. <i>Express Rights</i>	1050
1. Section 11 of the '33 Act.....	1051
a. <i>Generally</i>	1051
b. <i>Summary of Causal Elements</i>	1053

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2. Section 12(2) of the '33 Act	1056
a. <i>Generally</i>	1056
b. <i>Summary of Causal Elements</i>	1058
3. Section 18(a) of the '34 Act	1060
a. <i>Generally</i>	1060
b. <i>Summary of Causal Elements</i>	1062
4. Section 29(b) of the '34 Act	1064
5. Summary of the Express Private Rights for Misrepresentation	1066
6. Models Based on Types of Presumed Injuries...	1067
a. <i>The Face-to-Face Model—Transaction Causation</i>	1067
b. <i>The Open-Market Model—Transaction Price Causation</i>	1068
B. <i>Implied Rights</i>	1068
1. Rule 10b-5 Under the '34 Act.....	1068
a. <i>Generally</i>	1068
i. The Duty Not to Mislead	1071
ii. The Duty to Disclose or Refrain from Trading.....	1074
iii. Damages and Rescission.....	1076
b. <i>Summary of Causal Elements</i>	1080
2. The Express Models and Rule 10b-5	1081
a. <i>Rejecting the Common Law in Favor of Legislative Precedent</i>	1081
b. <i>Application of the Models</i>	1084
i. <i>Generally</i>	1084
ii. <i>Specific Comparisons</i>	1085
C. <i>Quasi-Express Rights</i>	1087
1. The Insider Trading and Securities Fraud En- forcement Act of 1988	1087
2. The Private Right for Contemporaneous Traders.....	1089
3. The Systemic Model—Causation Free	1090
4. Legislative Reenactment and the Interaction of Section 20A and Rule 10b-5.....	1091
5. The Models Revisited	1094
IV. CRITICISM AND CONCLUSION	1096

I. INTRODUCTION

In American legal tradition, causation has represented a critical logical link between an alleged wrongful act and any injury for

which civil liability may be imposed.¹ Throughout its history, the requirement of cause has led to extraordinarily difficult questions of both fact and law.² These questions have been particularly complicated in the context of liability under the federal securities laws. This complication arises both because Congress and the federal courts traditionally have adopted inconsistent approaches to cause³ and because of the manner in which Congress and these courts recently have interacted in resolving causal and related issues.⁴

The Securities Act of 1933 (the '33 Act)⁵ and the Securities Exchange Act of 1934 (the '34 Act)⁶ provide investors with a variety of rights of action. Many of these rights are premised on the misrepresentation or omission of information in the purchase or sale of a security.⁷ The misrepresentation rights discussed below are "private" in that they may be exercised by investors themselves rather than by some governmental entity acting on the public's behalf.⁸ In some cases, the language of one or more of the applicable federal securities statutes expressly describes the ability to sue privately.⁹ In other cases, the federal judiciary has implied the existence

¹ Cf. L. GREEN, *RATIONALE OF PROXIMATE CAUSE* 132 (1927) ("Causal relation is the universal factor common to all legal liability."); S. SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 109 (1987) ("A basic feature of all legal systems is that a party's behavior must have been what has here been called a necessary cause of an accident for liability to be found.")

² See *infra* notes 23-89 and accompanying text for a discussion of both the reasons for the causal requirement and the difficulties in its execution.

³ See *infra* notes 104-115 and accompanying text.

⁴ See *infra* notes 337-57 and accompanying text.

⁵ Securities Act of 1933, 15 U.S.C. §§ 77a-77bb (1988).

⁶ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1988).

⁷ In this article, for purposes of convenience, these rights will be referred to as "misrepresentation rights." Such rights include those based on sections 11, 12(2), and 17(a) of the '33 Act, sections 18(a) and 29(b) of the '34 Act, and rule 10b-5 under the '34 Act. This article omits discussion of the express private right provided under section 9(e) of the '34 Act, 15 U.S.C. § 78i(e) (1988) (see generally Silberberg & Pollack, *Are the Courts Expanding the Meaning of "Manipulation" Under the Federal Securities Laws?*, 11 SEC. REG. L.J. 265, 266-67 (1983)), and any implied private rights available under '34 Act § 13, 15 U.S.C. § 78m (1988), § 4, 15 U.S.C. § 78n (1988), or § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1988) (see generally Scott, *A Broker-Dealer's Civil Liability to Investors for Fraud: An Implied Private Right of Action Under Section 15(c)(1) of the Securities Exchange Act of 1934*, 63 IND. L.J. 687 (1988)). Although these sections are applicable to instances of misrepresentation or omission as those terms are used in this article, any rights existing under these sections are more specialized than those with which this article primarily is concerned. In addition, the lack of settled precedent regarding the existence and/or interpretation of certain of these rights renders discussion more speculative than is desirable.

⁸ For a brief description of the various aspects of governmental enforcement of the federal securities laws, see I. T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 9.5 (2d ed. 1990).

⁹ E.g., '33 Act § 11, 15 U.S.C. § 77k (1988) (see *infra* notes 123-49 and accompanying

of a private right of action, primarily on the basis of perceived legislative intent.¹⁰

Although courts have determined the existence of implied private rights by reference to congressional desires, they have determined the scope of such rights somewhat differently. In deriving the elements of implied private rights based on misrepresentation, federal courts have tended to seek precedent primarily in state common law.¹¹ As a result, one can easily distinguish legislative and judicial attitudes toward the role of cause. For decades, Congress has demonstrated considerable flexibility in dealing with causal requirements, treating them as means rather than ends.¹² In contrast, courts have been extremely timid in relaxing the traditional "but for" requirements of the common law.¹³

In the last few years, however, courts have signaled a sporadic willingness to disregard common law traditions.¹⁴ At the same time,

text); '33 Act § 12(1), 15 U.S.C. § 77l(1) (1988); '33 Act § 12(2), 15 U.S.C. § 77l(2) (1988) (see *infra* notes 150-78 and accompanying text); '34 Act § 9(e), 15 U.S.C. § 78i(e) (1988); '34 Act § 16(b), 15 U.S.C. § 78p(b) (1988); '34 Act § 18(a), 15 U.S.C. § 78r(a) (1988) (see *infra* notes 179-95 and accompanying text). This article also will view section 29(b) of the '34 Act, 15 U.S.C. § 78cc(b) (1988), as giving rise to an express private right of action. See *infra* notes 196-210 and accompanying text.

¹⁰ *E.g.*, '33 Act § 17(a), 15 U.S.C. § 77q (1988) (see *infra* note 217 for a discussion of the dubious nature of any such right); '34 Act § 10, 15 U.S.C. § 78j (1988) (see *infra* notes 217-90 and accompanying text); '34 Act § 13, 15 U.S.C. § 78m (1988); '34 Act § 14, 15 U.S.C. § 78n (1988); '34 Act § 15, 15 U.S.C. § 78o (1988). The existence of some of these rights is firmly established but the existence of others is not. See generally Hazen, *Implied Private Remedies Under Federal Statutes: Neither a Death Knell nor a Moratorium—Civil Rights, Securities Regulation, and Beyond*, 33 VAND. L. REV. 1333, 1339-43 (1980); Maher, *Implied Private Rights of Action and the Federal Securities Laws: A Historical Perspective*, 37 WASH. & LEE L. REV. 783, 789-808 (1980); Pitt, *Standing to Sue Under the Williams Act After Chris-Craft: A Leaky Ship on Troubled Waters*, 34 BUS. LAW. 117 (1978); Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME L. REV. 33, 33-44 (1979).

¹¹ See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975); *Dupuy v. Dupuy*, 551 F.2d 1005, 1018 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); 3 L. LOSS, *SECURITIES REGULATION* 1759-63 (2d ed. 1961); 6 L. LOSS, *SECURITIES REGULATION* 3880 (2d ed. Supp. 1969); Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469, 471 (1988); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561, 575-83 (1975). For limits on this reliance, however, see *Globus v. Law Research Service*, 418 F.2d 1276, 1291 (2d Cir. 1969) (noting that securities laws are to be interpreted liberally, and that there "need not be present all of the same elements essential to a common law fraud"), *cert. denied*, 397 U.S. 913 (1970); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 585 n.7 (1975) (noting that "the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit") (quoting 3 L. Loss, *supra*, at 1435); see also the authorities cited *infra* note 14.

¹² See *infra* notes 58-77 and 211 and accompanying text.

¹³ See *infra* text accompanying notes 285-90.

¹⁴ For instance, in both *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54

they intermittently have embraced arguments based on currently popular economic theories.¹⁵ As an unintended consequence, general legislative and judicial approaches to cause have been somewhat less divergent.

Nonetheless, there is no genuine trend toward uniformity in the treatment of cause. For instance, recent developments¹⁶ reveal that in cases involving the *express* misrepresentation rights, the strength of demands that the plaintiff establish causation varies inversely to the strength of demands that he or she demonstrate privity with the defendant.¹⁷ The *implied* misrepresentation rights simply do not follow this pattern, suggesting the existence of a perplexing systemic inconsistency.¹⁸ The primary focus of this article is this and other systemic inconsistencies involving cause and the misrepresentation rights.¹⁹

Part II of this article provides background on theories of causation and the general roles of cause in regulatory schemes.²⁰ Part III briefly describes the causal requisites of each of the misrepresentation rights under the federal securities laws, attempts to account for their differences, and suggests a method by which these

(1972), and *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-45 (1988), the Supreme Court liberalized the hitherto strict causal requirements imported into rule 10b-5 from the common law tort of misrepresentation. See *infra* text accompanying notes 239-48; see also *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 307 (1985) (inappropriate to invoke broad common-law barriers to relief where a private suit serves important public purposes); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 (1983) (reference to common-law practice can be misleading). Courts also have indicated a somewhat increased willingness to rely on express causes of action in resolving such matters as appropriate statutes of limitation, rather than regarding the common law as dispositive. See *infra* text accompanying notes 232-33.

¹⁵ See, e.g., *Levinson*, 485 U.S. at 246-47 (favorable discussion of the efficient market hypothesis but without wholehearted endorsement). For examples of general reliance on this theory by the federal circuit courts of appeal, see also *Lipton v. Documentation, Inc.* 734 F.2d 740, 743 (11th Cir. 1984); *T.J. Roney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330, 1332 (10th Cir. 1983); *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d Cir. 1981), *vacated sub nom. Price Waterhouse v. Panzire*, 459 U.S. 1027 (1982); *Shores v. Sklar*, 647 F.2d 462, 471 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1982); *Blackie v. Barrack*, 524 F.2d 891, 903-06 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). See *infra* notes 244-49 and accompanying text.

¹⁶ See *infra* notes 154-56, 162-66 and accompanying text.

¹⁷ See *infra* text accompanying notes 211-16.

¹⁸ See *infra* note 313 and accompanying text.

¹⁹ An analysis of causation, and the roles it plays in the private rights based on misrepresentation, assists in the identification of models useful in predicting and shaping the future of the misrepresentation rights themselves. Such an analysis also generally provides valuable information about the interactive decision-making processes employed by Congress and the courts. Discussion of these processes is a secondary purpose of this article.

²⁰ See *infra* notes 23-114 and accompanying text.

differences can be reconciled.²¹ This method involves development of models premised on the causal requisites of the express misrepresentation rights and use of these models in structuring the implied misrepresentation rights. Part IV addresses the principal problems confronted under this method, most of which are the result of recently exhibited and perhaps temporary congressional behavior.²²

II. THEORIES AND ROLES OF CAUSATION

A. Theories of Causation

In order to compare the approaches to causation respectively employed by Congress and the federal courts, one must investigate the traditional parameters of the concept of cause. This investigation provides both definitional background and insight into the possible motivations underlying the respective choices made by legislatures and the judiciary. As an initial step, it is useful to separate the component of cause-in-fact from the component of cause-in-law.²³

1. Cause-in-Fact or "But For" Causation

At common law, one familiar manner of framing the requisite factual connection between a defendant's act and a plaintiff's injury is that "but for" the defendant's bad act, the plaintiff's injury would not have occurred.²⁴ Nonetheless, courts have developed a more modern formulation to address difficulties that arise where the facts suggest that two or more causes exist.²⁵ This formulation is the

²¹ See *infra* notes 115-359 and accompanying text.

²² See *infra* notes 360-73 and accompanying text.

²³ See, e.g., H.L.A. HART & A. HONORÉ, CAUSATION IN THE LAW 79-102 (1959); Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69, 71-73 (1975); Green, *The Causal Relation Issue in Negligence Law*, 60 MICH. L. REV. 543, 548-49 (1962); Malone, *Ruminations on Cause-In-Fact*, 9 STAN. L. REV. 60, 97-99 (1956).

²⁴ Malone, *supra* note 23, at 65; see W. PROSSER & W.P. KEETON, THE LAW OF TORTS § 41, at 239 (5th ed. 1984) [hereinafter "PROSSER & KEETON"].

²⁵ See, e.g., *Anderson v. Minneapolis, St. P. & S. Ste. M. Ry.*, 146 Minn. 430, 432, 179 N.W. 45, 46 (1920) (either of the two fires that merged and destroyed plaintiff's property might have caused the destruction).

"material element" or "substantial factor" test,²⁶ which asks whether the defendant's conduct was a material element and a substantial factor in bringing about the plaintiff's injury.²⁷

Inquiries about cause-in-fact cast in terms other than those of these relatively simple formulations tend to be somewhat confusing²⁸ and to require rephrasing depending on context. Nonetheless, alternate formulations sometimes appear, often concealing concern with factors other than strict factual causation. For instance, in the context of private actions for fraud,²⁹ courts have tended to frame their primary inquiry into cause as the question of whether the plaintiff reasonably relied on the defendant's misstatement.³⁰

²⁶ See *id.* Prosser & Keeton argue that the substantial factor test is an improvement over the "but for" test because it leads to the same results as the "but for" test where the latter is applicable. It also applies to situations where the "but for" test is not useful, such as multiple cause cases. PROSSER & KEETON, *supra* note 24, § 41, at 240; accord 1 J. DOOLEY, MODERN TORT LAW § 8.02 (1982). Nonetheless, commentators have found the substantial factor test itself problematic where there are possible multiple causes but only one cause-in-fact exists. See Zwier, "Cause In Fact" in *Tort Law—A Philosophical and Historical Examination*, 31 DE PAUL L. REV. 769, 803 (1982); Malone, *supra* note 23, at 88-97.

²⁷ See, e.g., *Dunham v. Village of Canisteo*, 303 N.Y. 498, 513, 104 N.E.2d 872, 880-81 (1957); *Anderson v. Minneapolis, St. P. & S. Ste. M. Ry.*, 146 Minn. 430, 432, 179 N.W. 45, 46 (1920), *overruled*, *Borshiem v. Great N.R. Co.*, 149 Minn. 210, 183 N.W. 519 (1921); *Carney v. Goodman*, 38 Tenn. App. 55, 62, 270 S.W.2d 572, 575 (1954); RESTATEMENT (SECOND) OF TORTS, §§ 431, 433 (1964).

The most consistently meaningful forms of the "but for" and "substantial factor" inquiries appear to be as follows. In the case of the "but for" test, if the defendant had acted in accordance with its duty, would the plaintiff's injury have taken place? In the case of the "substantial factor" test, was the defendant's failure to comply with his or her duty a material element and a substantial factor in bringing about the plaintiff's harm? These formulations apply both where the plaintiff's injury may be the result of the defendant's affirmative act and where it may be the consequence of duty-breaching inaction. Thus, where a defendant employer has failed in its statutory duty to provide its employees with protective goggles, it is meaningful to ask "had the defendant provided protective goggles, would the plaintiff's eye have been injured?" Where the defendant has punched the plaintiff in the face, it makes sense to ask "was the defendant's failure to act peaceably towards the plaintiff a substantial factor in bringing about the plaintiff's black eye?"

²⁸ *Cf.*, e.g., *Dombeck v. Chicago, M., St. P. & P.R. Co.*, 24 Wis. 2d 420, 425, 129 N.W.2d 185, 188 (1964) (court required to grapple with whether speed of train was cause of fatal accident where either more or less speed would have avoided contact).

²⁹ As used in this article, the term "fraud" will refer to common-law causes of action or include reference both to common-law causes of action and to the misrepresentation rights.

³⁰ In the federal securities context, see, e.g., *Thomas v. Duralite Co.*, 524 F.2d 577, 585-86 (3d Cir. 1975); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). Other courts, however, have separated actual and justifiable reliance and dealt with them as separate elements. See, e.g., *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 517 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973). Although, as indicated in the text, the primary causal inquiry involves reliance, courts also may inquire into the relationship of the misrepresentation and the extent of the loss suffered by the plaintiff. See *infra* notes 53-55 and accompanying text.

This formulation translates poorly when the alleged fraud is the result of omission.³¹ Perhaps more troubling, it merges the question of cause-in-fact with a policy concern about whether the plaintiff has acted in a particular desired manner.³² If one must articulate this latter concern in causal terms at all, it is more clearly a matter of proximate, rather than factual, cause.³³

From time to time, courts have varied not only the formulation of the cause-in-fact inquiry, but also the rigor of the required demonstration that factual causation exists. The plaintiff usually must introduce evidence from which reasonable persons might conclude that it is more probable that the injury in question was caused by defendant's conduct than that it was not.³⁴ For some recently identified purposes, however, a certain level of statistical correlation between two occurrences may suffice to sustain liability if the defendant is unable to disprove the existence of cause.³⁵

³¹ Among other things, this formulation seemingly requires the plaintiff to prove contemplation of the non-existence of the undisclosed facts, as well as the speculative acts that he or she would have taken had full information been received. See Merritt, *supra* note 11, at 472 n.8. Cf. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-54 (1972) (proof of materiality may substitute for proof of reliance in a case based on misrepresentation by nondisclosure).

³² Note, however, that a particular formulation may also reflect assumptions about the kinds of injury that most frequently take place in particular circumstances. Thus, for instance, there is some common sense appeal to an assumption that the usual injury arising from a falsehood has to do with misleading the plaintiff. When such an assumption is inappropriate (as where the fraud is on the market, rather than on the individual), however, the formulation should change. See generally *infra* notes 244-49 and accompanying text.

³³ *But see infra* note 55.

³⁴ See, e.g., *State of Maryland v. Manor Real Estate & Trust Co.*, 176 F.2d 414, 418 (4th Cir. 1949); *Simpson v. Logan Motor Co.*, 192 A.2d 122, 123-24 (D.C. 1963); *MacIntosh v. Great N. Ry. Co.*, 151 Minn. 527, 529, 188 N.W. 551, 553 (1922). Where the probabilities are no better than evenly balanced, the court will direct a verdict for the defendant. See, e.g., *Alrichter v. Shell Oil Co.*, 161 F. Supp. 46, 49 (D. Minn. 1958); *Lane v. Hampton*, 197 Va. 46, 49, 87 S.E.2d 803, 805 (1955). In the case of common-law fraud, a "clear and convincing" standard of proof frequently is applied to all elements of the plaintiff's case. This was rejected for purposes of civil liability under the federal securities acts in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983).

³⁵ This is the case, for instance, where a manufacturer is held liable on the basis of market share of the product causing the plaintiff's injury. See, e.g., *McCorinack v. Abbott Laboratories*, 617 F. Supp. 1521, 1524 (D. Mass. 1985); *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 613, 607 P.2d 924, 938, 163 Cal. Rptr. 132, 146, *cert. denied*, 449 U.S. 912 (1980); see also *Abel v. Eli Lilly & Co.*, 418 Mich. 311, 339, 343 N.W.2d 164, 170, *cert. denied*, 469 U.S. 833 (1984); *Minnich v. Ashland Oil Co.*, 15 Ohio St. 3d 396, 398, 473 N.E.2d 1199, 1200 (1984). *Contra* *Burnside v. Abbott Laboratories*, 351 Pa. Super. 264, 297, 505 A.2d 973, 986 (1985). See generally Note, *Compensating Victims of Occupational Disease*, 93 HARV. L. REV. 916 (1980); Comment, *DES and a Proposed Theory of Enterprise Liability*, 46 FORDHAM L. REV. 963 (1978).

Variations of this sort in the rigors of proof may have policy rationales as simple as a need to provide viability to a cause of action.³⁶ Discussions of cause-in-fact, however, often fail to address these matters directly. This circumlocution serves both to impede progress in resolving policy issues and to hamstring courts and litigants dealing with confusing precedent.³⁷ Part III provides examples of such difficulties in the federal securities area.

2. Cause-in-Law or Proximate Cause

The concept of cause-in-law constitutes a policy-based adjustment to the concept of cause-in-fact.³⁸ Thus, where a defendant's conduct is, under the standards discussed above, the factual cause of a plaintiff's injury, the court nonetheless may decline to impose liability by invoking notions of social utility. For instance, where a defendant's action did play a critical role in some Rube Goldberg³⁹ chain of events that led to an unpredictable injury to the plaintiff,⁴⁰

³⁶ For examples of this phenomenon in the federal securities context, see *Basic, Inc. v. Levinson*, 458 U.S. 224 (1988), and *Affiliated Ute Citizens v. United States*, 406 U.S. 1281 (1972), discussed *infra* notes 239-43 and 244-48, respectively. In the common-law tort context, examples are provided in "clearly established double fault and alternative liability" cases (see PROSSER & KEETON, *supra* note 24, § 4, at 271). See, e.g., *Murphy v. Taxicabs of Louisville, Inc.*, 330 S.W.2d 395, 398 (Ky. 1959); *Summers v. Tice*, 33 Cal. 2d 80, 84, 199 P.2d 1, 5 (1948), *overruled*, *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 912, *cert. denied*, 449 U.S. 912 (1980); *Eramdjian v. Interstate Bakery Corp.*, 153 Cal. App. 2d 590, 608, 315 P.2d 19, 29 (1957); see also *Sindell*, 26 Cal. 3d at 613, 607 P.2d at 938, 163 Cal. Rptr. at 146 (in products liability context, damages apportioned among defendants based on market share of injurious product unless cause disproved by defendant).

³⁷ See Green, *Proximate Cause In Texas Negligence Law*, 28 Tex. L. Rev. 471, 474-90 (1950) (discussing problems of Texas courts in reconciling concepts of proximate and factual cause).

³⁸ See, e.g., *Merritt*, *supra* note 11, at 501; *Malone*, *supra* note 23, at 97.

³⁹ Rubeen Lucius (Rube) Goldberg (1883-1970) was, among other things, a cartoonist famous for his drawings of inventions designed to achieve simple results by roundabout means. See generally *WHO WAS WHO IN AMERICA* 160 (Marquis, Who's Who, Inc. 1976).

⁴⁰ As one commentator pointed out, unforeseeable injuries may include those occurring to unforeseeable plaintiffs or to foreseeable plaintiffs in unforeseeable ways or to unforeseeable extents. Calabresi, *supra* note 23, at 93-100.

Palsgraf v. Long Island R.R. is a classic example of a case in which the facts implicate the doctrine of proximate cause. 248 N.Y. 339, 352, 162 N.E. 99, 103, *reh'g denied*, 249 N.Y. 511, 164 N.E. 564 (1928). In *Palsgraf*, railroad employees negligently assisted a passenger boarding a train, causing him to drop an unlabeled package containing fireworks. The fireworks exploded, causing scales on the other side of the platform to fall upon and injure Mrs. Palsgraf. The court concluded that the railroad was not liable. Interestingly, however, the court chose to articulate its conclusion in terms of the railroad's duty, not in terms of proximate cause. See *infra* note 47 and accompanying text.

a determination that imposition of liability would be unfair or otherwise undesirable may lead a court to conclude that the act in question was not a sufficient or "proximate" cause-in-law of the injury with which it was linked factually.⁴¹

Generally, the determination of proximate causation prominently features some evaluation of the foreseeability⁴² of undesirable outcomes.⁴³ According to some commentators, although it is socially beneficial to encourage defendants to calculate the costs of their actions in terms of foreseeable injuries to others, there is no valid purpose in forcing a reckoning with unpredictable events.⁴⁴ This emphasis also may express some conclusion about the defendant's moral culpability. In fact, both courts and commentators frequently have noted that where intentional wrongdoing is involved, the proximate cause requirement may become quite attenuated.⁴⁵

Traditionally, however, issues of causation, proximate or otherwise, will not arise unless the defendant has breached a duty—

⁴¹ See, e.g., *Johnson v. Greer*, 477 F.2d 101, 106 (5th Cir. 1973) (proper focus is on "logic, fairness and justice"); *Caputal v. Lindsay Co.*, 48 N.J. 69, 77-78, 222 A.2d 513, 517 (1966) (basing determination on "mixed considerations of logic, common sense, justice, policy and precedent"). Accordingly, proximate cause commonly is treated as a question of law, whereas cause-in-fact commonly is treated as a question for the trier of fact. See L. GREEN, *supra* note 1, at 135-41 (1927); see also PROSSER & KEETON, *supra* note 24, § 42, at 244 (proximate cause is a question of law).

⁴² See Calabresi, *supra* note 23, at 81.

⁴³ This evaluation may take the form of delineation of "zones of risk" or the like. For purposes of this article, however, it is unnecessary to distinguish among formulations using foreseeability, duty-risk, or other terminology. For more extensive treatment of these distinctions, see generally Calabresi, *supra* note 23, at 91-100; Thode, *Tort Analysis: Duty-Risk v. Proximate Cause and the Rational Allocation of Functions Between Judge and Jury*, 1977 UTAH L. REV. 1, 27-32; Note, *When Cause-In-Fact is More than a Fact: The Malone-Green Debate on the Role of Policy in Determining Factual Causation in Tort Law*, 44 LA. L. REV. 1519, 1520-25 (1984). For a discussion of various early formulations of proximate cause, see generally Beale, *The Proximate Consequences of an Act*, 33 HARV. L. REV. 633 (1920); Edgerton, *Legal Cause*, 72 U. PA. L. REV. 211 (1924); McLaughlin, *Proximate Cause*, 39 HARV. L. REV. 149 (1925); Smith, *Legal Cause in Actions of Tort*, 25 HARV. L. REV. 103 (1911).

⁴⁴ See Calabresi, *supra* note 23, at 81 ("Thus, in terms of collective deterrence the argument for a foreseeability requirement excluding many causally linked actions from liability is very strong."). See *infra* note 70 and accompanying text for the argument that forcing any such reckoning in fact would impose wasteful transaction costs.

⁴⁵ See, e.g., *Shades Ridge Holding Co. v. Cobbs, Allen & Hall Mortgage Co.*, 390 So. 2d 601, 609 (Ala. 1980) ("[E]ven very remote causation may be found where the defendant acted intentionally."); *Derosier v. New England Tel. & Tel. Co.*, 81 N.H. 451, 464, 130 A. 145, 152 (1925) ("For an intended injury the law is astute to discover even very remote causation."); RESTATEMENT (SECOND) OF TORTS § 435B, comment a (1964) ("[R]esponsibility for harmful consequences should be carried further in the case of one who does an intentionally wrongful act than in the case of one who is merely negligent or is not at fault.").

acted or failed to act in some specified way.⁴⁶ To some extent, evaluations of both foreseeability of outcomes and moral culpability also can be subsumed in articulations of the defendant's duty.⁴⁷ This is particularly apt to be the case where a private cause of action is premised, either expressly or impliedly, on a statutory requirement or prohibition.⁴⁸ Accordingly, a careful initial statement of the defendant's duty easily can reduce the need for additional policy forays, including those implicating foreseeability and blame.⁴⁹

3. Special Judicial Applications of Cause in Actions for Fraud

Many of the courts specifically considering the role of cause in actions for fraud have developed special applications of the general concepts outlined earlier in this Part.⁵⁰ First, they ask whether the allegedly fraudulent statement caused the plaintiff to enter into the

⁴⁶ See, however, Prosser and Keeton's statement that "duty is only a word with which we state our conclusions and no more." PROSSER & KEETON, *supra* note 24, § 43, at 281.

Another way of articulating the statement in the text is that requisite "fault" must be established. "Fault," however, does not necessarily involve moral reproach; it may mean only that there has been a departure from the conduct desired by society. See Seavey, *Speculations as to "Respondeat Superior,"* HARVARD LEGAL ESSAYS 433, 442 (1934). But see Keeton, *Conditional Fault in the Law of Torts*, 72 HARV. L. REV. 401 (1959) (arguing strict liability, viewed as liability without fault, is founded on a moral concept of "conditional fault"); see also Calabresi, *supra* note 23, at 82 ("Is fault not designed to select from an infinity of causally linked actions those which are by definition not worth doing, that is, wrongful or tortious?") (emphasis in original). In *United States v. Carroll Towing Co.*, Judge Learned Hand proposed a formula for determining the point at which fault might exist. 159 F.2d 169, 173 (2d Cir. 1947). In *A Theory of Negligence*, Posner re-articulated the Learned Hand formula in strict economic terms. 1 J. LEGAL STUD. 29 (1972).

⁴⁷ In fact, depending on a given court's approach, the overlap may be relatively complete. See, e.g., *Palsgraf v. Long Island R.R.*, discussed *supra* note 40; see also PROSSER & KEETON, *supra* note 24, § 42, at 274 ("[A]ll of these questions are, in reality, one and the same.").

⁴⁸ One might note in response to Prosser and Keeton's complaint that "duty" is a conclusion, *supra* note 46, that the conclusion in this circumstance at least has been drawn legislatively.

⁴⁹ This may account for the lack of any rigorous discussion of the concept of proximate cause in the securities field. See generally the several discussions of causal elements in Part II *infra*.

⁵⁰ See Merritt, *supra* note 11, at 495-500. According to Merritt, a majority of cases dealing with common-law fraud adopt an approach approximating that described in the text, albeit without the specific terminology of "transaction causation" and "loss causation." This specific terminology has become popular in the context of modern cases involving fraud under the federal securities laws. See, e.g., *Bennett v. United States Trust Co.*, 770 F.2d 457, 463 (2d Cir.), *cert. denied*, 474 U.S. 1058 (1986); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-82 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F. Supp. 1346, 1351 (W.D. Wash. 1986), *aff'd*, 823 F.2d 1349 (9th Cir. 1987); *In re Catanella Sec. Litig.*, 583 F. Supp. 1388, 1414-15 (E.D. Pa. 1984). Merritt also notes, however, that a significant minority of common-law cases do not make the kind of distinction described. Merritt, *supra* note 11, at 496, 498-500.

transaction in question, often casting their inquiry in terms of whether the plaintiff reasonably relied upon the suspect statement.⁵¹ If so, the element of "*transaction causation*" is established.⁵² Next, the courts inquire into "*loss causation*"—whether the injury complained of (typically a decline in the price for which the item acquired by the plaintiff may be sold) is attributable to the untruth of the statement for which the defendant is being sued, or is the result of some other factor, such as an unforeseeable accident or general market forces.

This two step process may be illustrated as follows: if a plaintiff proves that he or she would not have purchased a particular piece of property had it not been for a false representation that the property was commercially zoned,⁵³ transaction causation is established. If the property has been resold for substantially less than the amount the plaintiff paid, partly because it is not commercial property and partly because all property values in the area have suffered a decline, loss causation exists with respect to the former component of the plaintiff's loss, but not with respect to the latter.

Translated into the terminology previously introduced, the inquiry into transaction cause is an inquiry into "but for" causation.⁵⁴ If the defendant had dutifully told the truth, the plaintiff would not have entered the transaction, thus avoiding *any* loss associated with the property. Accordingly, the inquiry into loss causation may be seen as an attempt to limit liability in some manner conforming to a perception of what is fair or useful to charge to the defendant; in other words, an exercise in proximate cause.⁵⁵

⁵¹ In the securities context, see, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Shores v. Sklar*, 647 F.2d 462, 470 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 n.24 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

⁵² See cases cited at *supra* note 50.

⁵³ This hypothetical assumes, for purposes of simplicity, that the plaintiff's failure to inquire further was not unreasonable. With respect to the requirement that a plaintiff's reliance be reasonable, see generally Gabaldon, *Unclean Hands and Self-Inflicted Wounds: The Significance of Plaintiff Conduct in Actions for Misrepresentation Under Rule 10b-5*, 71 MINN. L. REV. 317, 319-27 (1986).

⁵⁴ See *Huddleston*, 640 F.2d at 547-49.

⁵⁵ See, e.g., *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20 (2d Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987); *In re Catanella Sec. Litig.*, 583 F. Supp. 1388, 1414-15 (E.D. Pa. 1984). Nonetheless, limitations related to loss causation in this context also may respond to the idea that the plaintiff might have bought some other piece of property and suffered some general decline in investment value even if the defendant made no misrepresentation—a type of "but for" causal concern because, had the defendant

There are circumstances, however, in which the differentiation between transaction and loss causation does more to confuse than illumine. If, for instance, the transaction simply would have gone through at a different price⁵⁶ had the truth been told, then the transaction cause concept is not helpful. In this case, loss causation itself is a "but for" inquiry presumably directed at determining the difference between the actual price of the transaction and the hypothetical price at which it would have taken place had the truth been known. Therefore, it may be more helpful in these circumstances to abandon the transaction/loss vocabulary and to refer only to some such concept as *causation of transaction price*.

4. The Distinction Reconsidered

Both the foregoing discussion and the traditional proximate/"but for" dichotomy more or less presuppose some virtue to a distinction between policy considerations and the identification of cause-in-fact. One such virtue is clarity in dealing with policy.⁵⁷ In addition, does value exist in starkly revealing the outlines of cause-in-fact? In other words, should legislatures, courts, and commentators really be preoccupied with the existence of factual cause?

a. *Cause as a Means to Other Ends*

In some private rights of action, the element of factual causation itself probably is used to establish some rational limit on a defendant's possible liability.⁵⁸ In most cases, this use of factual cause may not be necessary because liability already is limited effectively

performed his or her duty, an injury still would have been sustained. See *supra* text accompanying note 30.

⁵⁶ Disclosure could, of course, affect some term other than price. Nonetheless, the example of price is used throughout this article for purposes of simplicity.

⁵⁷ See *supra* text accompanying notes 33-34.

⁵⁸ As the court noted in *North v. Johnson*, infinite liability for wrongful acts would "set society on edge and fill the courts with endless litigation." 58 Minn. 242, 245, 59 N.W. 1012, 1012 (1894); see also *Zwier*, *supra* note 26, at 773 ("[A]s fault principles are deemphasized . . . the cause in fact requirement may be the only major hurdle facing plaintiff's attempt to secure recovery."). The relevant worry also may be the imposition of manageable limits on the work of the courts. Concern with limiting litigation has, for instance, been a consistent theme throughout the development of rule 10b-5 case law. Cf. *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 739-49 (1975) (discussing the possibility of vexatious litigation). Some courts have cited the adoption of the scienter standard as alleviating this problem. See *infra* notes 228-29 and accompanying text. See, e.g., *Straub v. Vaisman and Co.*, 540 F.2d 591, 597 (3d Cir. 1976).

by the requirement that the plaintiff's injury be foreseeable.⁵⁹ There are circumstances, however, in which it is foreseeable that any of a number of plaintiffs might be injured, but certain that not all of them will be. Thus, a defendant's duty-breaching actions might pose a foreseeable risk to one thousand individuals,⁶⁰ but actually result in injury to only two or three.⁶¹ Overcompensation and overdeterrence might result if courts permitted all individuals within the zone of risk to bring a cause of action. At the same time, dividing the monetary value of two or three average causes of action among the thousand individuals placed at risk is a distinctly unsatisfying proposition for at least two reasons. First, those individuals who are injured by the defendant's act will not be fully compensated.⁶² Second, division of a cause of action is likely to mean that no individual plaintiff will have an appropriate incentive to file suit. In other words, a type of "free rider" problem is created.⁶³

The requirement of cause-in-fact also may serve as a method of allocating private lawsuits among appropriate defendants. For example, if each of two manufacturers of the same product occasionally produces defective merchandise purchased by the same group of possible plaintiffs, the element of factual causation assures that not all suits are brought against the wealthier manufacturer, or the one that consumers have most often sued successfully in the past. This outcome presumably has the effect of appropriately impressing *all* possible defendants⁶⁴ with the need for caution.⁶⁵

⁵⁹ Foreseeability of injury may be incorporated into either the definition of the defendant's duty or the parameters of proximate cause.

⁶⁰ Here, the fact that risk is created presumably is defined as a breach of duty.

⁶¹ For instance, this might arise where two or three defective products are produced out of every 1000 manufactured. However, the statement in the text disregards the damage such as mental suffering or increased insurance rates that exposure to risk may occasion even where no other injury is sustained.

⁶² If, however, there are other individuals who have suffered injuries not caused by the defendant, they nonetheless may need compensation from some source. In other words, why should the plaintiff who was lucky enough to be injured by reason of flammable pajamas be favored over one who was struck by lightning? For discussion of this and related issues, see *infra* text accompanying notes 69-70.

⁶³ "Free rider" or "public good" problems are the result of a reluctance to engage in what would otherwise be optimal levels of a particular activity because the benefits of the activity must be shared. See generally C. GOETZ, *CASES AND MATERIALS ON LAW AND ECONOMICS* 27-28, 98 (1984).

⁶⁴ In some circumstances, it may be potential plaintiffs who are to be impressed. Thus, given the requirement of cause-in-fact, no purchaser of flammable pajamas will be encouraged to regard them as a form of fire insurance.

⁶⁵ There is, of course, less need for such a requirement where courts have adopted a pooling approach to liability. See *supra* note 35 and accompanying text.

The foregoing explanations of factual causation as means to desired ends are related to one well-known commentator's assessment that "[it] is simply a useful way of toting up some of the costs the cheapest cost avoider should face in deciding whether avoidance is worthwhile."⁶⁶ Part IIA(5) below presses this type of means-end explanation, based on desired effects on behavior, to a stark conclusion with specific reference to liability for misrepresentation.

b. *Other Factors*⁶⁷

Nonetheless, it is difficult to address all historically identifiable requirements of cause-in-fact in precisely the means-end terms just described.⁶⁸ For instance, cause-in-fact (or lack thereof) typically justifies the following outcomes: Assume that "X" is a nonnegligent individual struck and killed by defendant "W's" unlawfully speeding car, and that "Y" is a nonnegligent individual killed by lightning in the split-second before being hit by that same speeding car. A court typically would permit the survivors of "X" to recover against "W," but would preclude an action by the survivors of "Y" on the basis of lack of "but for" cause. Because neither driver nor decedent could anticipate the intervention of nature, however, any traditional means-end explanation based on desired effect on behavior is not apt to sustain such a distinction.

A distaste for windfalls to plaintiffs⁶⁹ might explain these divergent outcomes. Such distaste may be understandable in terms of

⁶⁶ Calabresi, *supra* note 23, at 85.

⁶⁷ See generally G. CALABRESI, *THE COSTS OF ACCIDENTS* 297-99 (1970) (discussing society's requirement of a one-to-one relationship between injurer and injured in terms of retribution and other factors).

⁶⁸ In addition, cost avoidance theories seem mildly strained as explanations for the impulse of legislatures to attach higher sanctions to "completed" crimes, such as murder, than to "attempted" crimes, such as attempted murder. See *infra* note 92 and accompanying text. The strictly economic approach described in Part IIA5, *infra*, labels the punishment of inchoate crimes "puzzling." See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 172 (2d ed. 1977) (the criminal sanction is a method of pricing conduct, but an unsuccessful crime has no costs).

For discussion of the appropriate extent of criminal responsibility for arguably resulting consequences, see, e.g., Ryu, *Causation in Criminal Law*, 106 U. PA. L. REV. 773, 775-86, 800-05 (1958).

⁶⁹ If this factor were not at play, it would be mildly difficult to explain a legal system's willingness to accept legislatively defined penalties not determined by the extent of the injury caused (and payable into the public pocket) while at the same time spawning a judiciary determined to avoid a similar result when the penalty is payable to an individual. Note, however, that legislatures do sometimes provide for "windfall" payments into private pockets. See, e.g., section 4 of the Clayton Act, 15 U.S.C. § 15 (1988) (treble damages for certain

reluctance to compensate the survivors of "Y" as long as the survivors of "Z," an individual struck by lightning when no car is in sight, have no remedy. The juxtaposition of the "X," "Y," and "Z" hypotheticals, however, certainly suggests that there must be either a windfall to the defendant saved by lightning or a windfall to the survivors of the person felled by it. Because there does not seem to be very good reason to prefer negligent or reckless defendants over the survivors of innocent decedents, something else must validate this result. Simple avoidance of litigation expense supplies one explanation for why costs should lie where they fall, but this rationale is unaffected by the presence or absence of "but for" cause.⁷⁰

An alternate explanation is based on the idea that private causes of action have a retributive component requiring causal relationship as a matter of inherent morality.⁷¹ Such an argument demands intuitive recognition that defendants "deserve" to be liable only for results that they, rather than forces of nature, etc., have "caused." In fact, more than one scholar has traced the cause-in-fact requirement in private rights of action to the vengeance customs of ancient peoples.⁷²

antitrust violations); section 16(b) of the '34 Act (discussed *infra* note 97); *infra* text accompanying note 319.

⁷⁰ Justice Holmes himself gave minimization of administrative costs as the reason for letting the costs lie where they fall unless some clear societal benefit is achieved by shifting them. See O.W. HOLMES, JR., *THE COMMON LAW* 76-77 (Howe ed. 1963). One such benefit, of course, would be compensation; another would be deterrence.

⁷¹ The impulse of legislatures to attach higher sanctions to "completed" crimes than to "attempted" crimes seems to reflect some notion of a moral value inherent in the establishment of causal relationship. See *supra* note 68 and *infra* note 92 and accompanying text; see also the justification discussed by Calabresi, *supra* note 23, at 79. The rather commonly articulated concept that someone subject to punitive sanctions is "paying a debt to society," when combined with the fact of sliding-scale punishments, suggests that social debts are larger when undesirable results actually are achieved. Cf. C. KENNY, *OUTLINES OF CRIMINAL LAW* ch. 1 (5th ed. 1936) (A crime is an offense against the public at large, and the purpose of a criminal proceeding is to protect and vindicate the interest of the public as a whole). This analysis has a distinctly retributive flavor. The whole "debt" concept, moreover, suggests that retribution at times may be a kind of compensation to a societal psyche injured by reason of fear, outrage, or the like. This reasoning ties well into recent treatment of individuals trading on the basis of inside information. See *infra* note 332 and accompanying text.

⁷² See Zwier, *supra* note 26, at 781; O.W. HOLMES, JR., *supra* note 70, at 7-8; Wigmore, *Responsibility for Tortious Acts: Its History*, 7 HARV. L. REV. 315, 316-18 (1894). For a general discussion of the retributive value of cause-in-fact requirements in the field of torts, see, e.g., G. Calabresi, *supra* note 67, at 298-99; Chapman, *Ethical Issues in the Law of Tort*, 20 U.W. ONTARIO L. REV. 1, 6 (1982) ("[A]spects of the retributive theory [of tort liability] seem . . . to loom large in explaining the legal concern for cause-in-fact."); Zwier, *supra*, at 784 ("[T]he cause in fact requirement can be traced to the desire for vengeance.").

Commentators also have explained the prolonged popularity of the requirement of cause-in-fact⁷³ as consistent with the ultra-individualist tradition in which the American judiciary is steeped.⁷⁴ After all, if the state properly may interfere with the liberty of individuals only when they have interfered with the liberty of others through force or fraud,⁷⁵ cause-in-fact can be regarded as a vital mechanism to assure that the predicate interference has occurred, thus restraining the action of the state.⁷⁶

The political model of the minimalist state, however, now has lost a considerable amount of acceptance.⁷⁷ To the extent that this model can no longer theoretically justify the cause-in-fact requirement, something else must explain the requirement's continued attraction for courts or other decision makers choosing to apply it. This "something else" could be one of the more naked forms of means-end analysis, simple devotion to precedent, or intuitive acceptance of the retribution theory described above.

5. The Strict Economic Approach

One well-known, if fairly recent, school of thought seeks to explain and evaluate legal developments in terms of movement toward economic efficiency. In this sense, a result is efficient if those benefited gain more than is lost by those detrimented.⁷⁸ The efficiency analysis is unaffected by whether or not there is actual com-

⁷³ See ZWIER, *supra* note 26, at 784-96.

⁷⁴ R. POUND, *THE SPIRIT OF THE COMMON LAW* 37 (1921) ("What is peculiar to Anglo-American legal thinking, and above all to American legal thinking, is an ultra-individualism, an uncompromising insistence upon individual interests and individual property as the focal point of jurisprudence."). Cf. 1 W. BLACKSTONE, *COMMENTARIES* 38-43 (primary purpose of all human laws is protection of individual rights). See generally L. FULLER, *THE MORALITY OF LAW* 96-106 (1964).

⁷⁵ See A. BROWN, *MODERN POLITICAL PHILOSOPHY* 88, 92 (1986) (describing classical libertarian philosophy); R. NOZICK, *ANARCHY, STATE AND UTOPIA* 26-28, 149 (1974); ZWIER, *supra* note 26, at 791.

⁷⁶ This discussion is, of course, a type of means-ends analysis not based on desired behavioral effect.

⁷⁷ See, e.g., Kelsen, *The Pure Theory of Law and Analytical Jurisprudence*, 55 *HARV. L. REV.* 44, 69 (1941) (the modern inclination is to a "universalistic philosophy of values according to which the community is superior to the individual").

⁷⁸ See W. LANDES & R. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 16 (1987). The method postulates a model of pre-act bargaining between would-be perpetrator and victim to determine whether the crime is economic (that is, whether the would-be perpetrator willingly would meet the victim's demanded price), but also recognizes that in the case of many crimes there is no feasible advance negotiation. R. POSNER, *supra* note 68, at 166. See generally *id.* at ch. 13.4, on the merits of *ex ante* vs. *ex post* control in such circumstances.

pensation moving from the benefited to the detrimented because it is overall, not individual, wealth maximization that is sought.⁷⁹ Although this school acknowledges that wealth distribution concerns⁸⁰ may be addressed even at the expense of efficiency,⁸¹ it regards the court system as a relatively inferior redistributive mechanism.⁸²

Assuming that the purpose of a given body of law is promotion of economic efficiency, "a defendant's conduct will be deemed the cause of an injury when making him liable for the consequences of the injury will promote an efficient allocation of resources When it would not promote efficiency for the defendant to behave differently, the cause of the accident will be ascribed to an 'act of God'."⁸³ Pursuant to strict economic analysis, then, the idea of causation is itself quite dispensable, except insofar as it represents a traditional vocabulary with which lawyers and judges may feel comfortable while grappling with efficiency concerns.⁸⁴

Accordingly, in determining the measurement of liability, an economist would bypass cause and inquire directly whether an activity such as misrepresentation has adverse economic consequences.⁸⁵ The typical conclusion has been to the effect that mis-

⁷⁹ A result efficient in this sense is to be distinguished from one that is pareto preferred. W. LANDES & R. POSNER, *supra* note 78, at 16. A result is pareto preferred if no change can make someone better off without making someone else worse off. *Id.*; see also A.M. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7 n.4 (1983).

⁸⁰ According to A.M. Polinsky, *supra* note 79, at 7, "[E]fficiency corresponds to 'the size of the pie,' while equity has to do with how it is sliced. Economists traditionally concentrate on how to maximize the size of the pie, leaving to others—such as legislators—the decision how to divide it." For criticism of the excesses of the strict economic approach toward this dichotomy, see, e.g., Calabresi, *The New Economic Analysis of Law: Scholarship, Sophistry or Self-Indulgence?*, LXVIII PROC. BRIT. ACAD. (1982).

⁸¹ A.M. POLINSKY, *supra* note 79, at 105-13.

⁸² *Id.* at 110-13; R. POSNER, *supra* note 68, at 404-05.

⁸³ W. LANDES & R. POSNER, *supra* note 78, at 229.

⁸⁴ *Id.*

⁸⁵ In the case of nondisclosure, however, a different analysis prevails. Although nondisclosure by the least-cost provider of information suggests the existence of diseconomies in the form of search costs incurred by less efficient producers of information, disclosure itself imposes both mechanical costs and costs in terms of disincentives to the production of information. See, e.g., Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681-82 (1984). This is, of course, a kind of "public good" or "free rider" problem. See *supra* note 63. Moreover, many legal economists postulate that marketplace competition generally will bring about disclosure without the need for legal enforcement mechanisms. See KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 117-33 (1979); R. POSNER, *supra* note 68, at 83, 332-34. For a summary of the earlier literature addressing the effect of regulation on the market for new issues, see G.J. BENSTON, *CORPORATE FINANCIAL DISCLOSURE IN THE U.K. AND THE U.S.A.* (1976). For a defense of mandatory disclosure systems, see, e.g., Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 748-49 (1984). The argument

representation imposes dead losses on society, including the risk of resource misallocation, the cost to the speaker of making the misrepresentation, and the cost to others of attempting to uncover it.⁸⁶ Therefore, a penalty is merited in an amount sufficient to deter the making of the misrepresentation. Moreover, because misrepresentation involves concealment, the possibility that the uneconomic act will go undetected requires an offsetting increase in the amount of the penalty.⁸⁷ The optimum penalty amount thus will be somewhat in excess of any individual gain anticipated by the party making the misrepresentation.⁸⁸ Correspondingly, this optimum amount also may exceed any loss "caused" by the undesirable act. The decision as to who should collect the penalty is a matter of less interest to the economist and presumably is to be determined by some other competent decision-maker by reference to equity and other considerations.⁸⁹

6. Summary of Theories of Causation

In summary, causation fulfills several purposes that vary in the eye of the beholder. To some, causal relationships may represent a crucial, if intuitive, link without which punishment (or other legal responsibility) may not be morally imposed. Others may regard such

based on marketplace competition often leads to the conclusion that affirmative disclosure should not be mandated except in the limited case where disclosure is necessary to keep other revealed information from being misleading. There, it seems that the analysis pertaining to misrepresentations more properly would apply.

⁸⁶ See W. LANDES & R. POSNER, *supra* note 78, at 154; R. POSNER, *supra* note 68, at 81; Easterbrook & Fischel, *supra* note 85, at 673-80; Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119, 129-31 (1981).

Typically, misrepresentation also will involve a wealth transfer which, as an "equity" issue, itself is relatively uninteresting to the legal economists. See *supra* note 80; see also W. LANDES & R. POSNER, *supra* note 78, at 255. This might involve a transfer from the deceived to the misrepresenter or, in some cases, between two third parties. For instance, a misrepresentation made by the issuer of securities into an existing trading market affects sales to which the issuer is not party. In the case of misrepresentations relating to new issues of stock, there also is some danger of misallocation of investment funds. See Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334-36 (1979). In the long run, however, the dangers of misallocation presumably would be overcome by sufficient investigation by investors.

⁸⁷ See, e.g., W. LANDES & R. POSNER, *supra* note 78, at 160. See generally Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

⁸⁸ See, e.g., Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1125 (1972) (discussing additional reasons for optimal penalties to exceed objective valuations of the defendant's gain).

⁸⁹ See *supra* note 80 and accompanying text.

relationships as necessary to the preservation of individual autonomy and the restraint of the action of the state.

Nonetheless, many commentators acknowledge that at least some aspects of cause are not inherently valuable, but rather are means to ends. Thus, for instance, both proximate cause and cause-in-fact at times may constitute methods of limiting liability while impressing upon possible defendants the need to evaluate the net benefits of their actions from both internal and external viewpoints. One should recognize, however, that if any given decision-maker views cause as no more than a means to an end, other methods of achieving the same goal often will be available, sometimes offering greater simplicity or different advantage.

B. *Roles of Causation in Regulatory Schemes and in Private Rights of Action Based on Those Schemes*

In devising a regulatory scheme,⁹⁰ a legislature may address its goals in at least two general ways. First, it may choose to prohibit or require behaviors actually causing specific outcomes.⁹¹ Second, it simply may regulate actions without reference to the attainment of particular results. For instance, a legislature concerned about violent deaths might outlaw murder (intentional activity resulting in death of another), and attempted murder (intentional activity directed toward the death of another but falling short of that result), as well as discharge of a firearm in populated areas (intentional or unintentional activity merely risking injury or death of another).⁹²

A legislature sometimes may regulate activities without regard to any necessary result simply because it finds the activities them-

⁹⁰ As used in this article, the term "regulatory scheme" refers to legislation directly addressing the behavior of those who are not governmental employees. The conduct of employees also typically will be implicated, at least by way of a duty to enforce.

⁹¹ For purposes of convenience, except where otherwise indicated, the regulatory models discussed in Part II of this article are based on prohibition rather than mandate. Part III will focus on the federal securities regulatory scheme, which is a hybrid of prohibition and mandate.

⁹² In making these regulatory choices, such a legislature often would take pains to correlate the strength of enforcement mechanisms, *i.e.*, severity of punishment, and the regulated party's actual attainment of undesirable results. Thus, for instance, murder may carry a higher penalty than attempted murder. *See, e.g.*, MODEL PENAL CODE § 5.05(1) (1985) (characterizing an attempt to commit a capital crime or first degree felony as a felony of the second degree); *id.* § 6.06(1)-(2) (establishing a longer term of imprisonment for first degree felonies than for those of the second degree). *See Calabresi, supra* note 23, at 79 for a discussion of the use of completion of a crime as evidence of intent justifying imposition of a penalty stronger than that imposed on an uncompleted crime. *See generally* Glazebrook, *Should We Have a Law of Attempted Crime?*, 85 L.Q. REV. 28, 35-44 (1969); Sayre, *Criminal Attempts*, 41 HARV. L. REV. 821, 837-42 (1928).

selves either desirable or objectionable.⁹³ Similarly, it may proscribe or require particular behaviors without reference to their actual results because they frequently are linked with particular occurrences.⁹⁴ The enacting body may or may not examine carefully whether the usual linkage is in the nature of "but for" causation,⁹⁵ or is merely a predictive relationship⁹⁶ based on observations that undesirable event B tends to occur at the same time as, or shortly after, event A.

Where a legislature expressly provides that a private citizen has a right of action based on the conduct of another, it may choose to address causal linkage in any number of ways. First, it simply might designate certain individuals as "private attorneys general," who are empowered to bring lawsuits for specified amounts without reference to any injury to themselves.⁹⁷ Second, it instead might require some proof of injury but no strict demonstration that it was the defendant's behavior that caused the injury.⁹⁸ Alternately, it might

⁹³ See Calabresi, *supra* note 23, at 78 n.12 for the argument that behavior sometimes is forbidden because some people are "shocked" by it, and that being shocked is being harmed. See also Calabresi & Melamed, *supra* note 88, at 1102 n.30.

Insider trading is an example of an activity deemed by the United States Congress to be inherently objectionable, notwithstanding voluminous writings on its economically desirable outcomes. See *infra* note 337 and accompanying text.

⁹⁴ An activity such as attempted murder, described in terms of failure at an attempt to achieve the consequence of death of an intended victim, may fall in the category of activities proscribed as inherently objectionable insofar as it involves formation of an inherently objectionable intent independently worthy of punishment. If intent to kill is causally linked with the disagreeable consequence of death of a victim, however, the attempt might be proscribed as a means of preventing that consequence. For discussion of the argument that proscription of attempts has no more deterrent effect than already is supplied by proscription of the completed act, see G. DIX & M.M. SHARLOT, *CRIMINAL LAW* 555 (3d ed. 1987). A clearer example of preventive regulation is proscription of an act, such as discharging a firearm within city limits, because it is believed that if no firearms are discharged, no one will die of gunshot wounds. The relative strength of the proscriptions directed at various activities may reflect an assessment about inherent undesirability, as well as about the strength of the causal relationships involved. See generally Glazebrook, *supra* note 92.

⁹⁵ See *supra* note 24-37 and accompanying text.

⁹⁶ See Calabresi, *supra* note 23, at 71-72 for differentiation of the predictive concept of "causal link" and the concept of "but for" cause. Malone has argued that "proof of what we call the relation of cause and effect . . . can be nothing more than 'the projection of our habit of expecting certain consequents to follow certain antecedents merely because we had observed these sequences on previous occasions.'" Malone, *supra* note 23, at 64-65 (quoting W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 44, at 223 (2d ed. 1955)).

⁹⁷ Section 16(b) of the '34 Act, 15 U.S.C. § 78p(b) (1988), provides one example of such an approach. Section 16(b) permits shareholders in specified circumstances to bring a quasi-derivative suit for the disgorgement of short-swing profits by insiders without any demonstration of injury to the corporation. See generally 2 L. Loss, *supra* note 11, at 1037-44.

⁹⁸ This might be the case, for instance, where the burden of disproving causation is placed on the defendant. See *infra* notes 135 and 140 for a discussion of section 11 of the '33 Act.

demand strict "but for" causation.⁹⁹ Presumably, the selection among these or other variations is well-considered and designed to reflect such factors as perceived morality, desirability of deterrence, and avoidance of windfalls.¹⁰⁰ As illustrated in the federal securities context, a variety of approaches frequently is the order of the day.¹⁰¹

Even where the legislature has failed to provide expressly for the existence of private rights, courts have implied them under some circumstances.¹⁰² Generally, the process of implication involves a scrutiny of the statutory language, the structure of the regulatory scheme, and the legislative history for evidence of legislative intent—the talisman upon which the existence of the private right is said to depend.¹⁰³

Where courts imply a private right of action for damages¹⁰⁴ from a regulatory prohibition or mandate, they clearly do not regard themselves as enjoying any substantial degree of flexibility¹⁰⁵ in dealing with the relationship between the regulated activity and its result.¹⁰⁶ One may explain this conservatism in at least two ways.

⁹⁹ See *supra* text accompanying notes 24–37 for a general discussion of "but for" causation. See also *infra* notes 181–85 for a discussion of section 18(a) of the '34 Act.

¹⁰⁰ See *supra* text accompanying notes 57–89.

¹⁰¹ See *infra* notes 116–215 and accompanying text.

¹⁰² See generally Ashford, *Implied Causes of Action Under Federal Law: Calling The Court Back to Borak*, 779 NW. U.L. REV. 227, 234–74 (1984); Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 554–70 (1981); Hazen, *supra* note 10, at 1339–43. As these commentators point out, the dominating impression of the implication process as practiced over the last decade is one of conservatism.

¹⁰³ For further discussion of the factors listed in the text and other factors, such as traditional relegation to state law, see *supra* note 102; L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 926–43 (1988).

¹⁰⁴ Except where otherwise specified, this article is limited to private rights of action for damages or rescission, as distinguished from actions seeking non-rescissory equitable remedies. Rescission logically may be viewed as a short-handed economic equivalent of certain damage calculations even more than might be other forms of injunctive relief.

¹⁰⁵ *Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 65 (1938), abolished the notion of a general federal common law. Commentators have widely discussed the implications of this abolition for the power of the federal courts. See, e.g., Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964) (supporting a specialized federal common law); Green, *Judicial Implication of Remedies for Federal Statutory Violations: The Separation of Powers Concerns*, 53 TEMP. L.Q. 469, 488–505 (1980) (advocating private causes of action arising from violations of federal statutes without specific congressional directive); Hazen, *supra* note 10, at 1347 (no independently existing federal causes of action after *Erie*); Note, *Implied Causes of Action: A Product of Statutory Construction or the Federal Common Law Power?*, 51 U. COLO. L. REV. 355, 380–96 (1980) (advocating implication of remedies as a matter of federal common law).

¹⁰⁶ For illustrations in the federal securities context, see *infra* text accompanying notes 248–50, 260, and 286–90.

As a more general matter, courts usually do not imply a private right of action from a

First, the process by which a private right is implied from a regulatory provision focuses on existence of the right, but not its shape. This permits the courts to shape the right through allusion to common law precedent where the requirement of cause is well established.¹⁰⁷ Second, and more importantly, courts may regard cause as a means of assuring that implied private rights of action fulfill some goal other than augmentation of the deterrent and punitive effects of the regulatory system without implied rights.¹⁰⁸

This second point may be further explained as follows. In the case of the implied rights, the legislature has performed the primary balancing of legal regulation¹⁰⁹ against the benefits of the defendant behaviors sought to be regulated.¹¹⁰ The express civil and criminal penalties presumably embody the legislature's initial judgment about appropriate deterrent and punitive levels. Thus, the theoretical role left for the implied private right would appear to relate to the plaintiff's moral right to receive compensation from the perpetrator of his or her injury.¹¹¹ Accordingly, relaxation of causal requirements to address such problems as underdeterrence might be characterized as a type of judicial challenge to legislative competence.¹¹² In fact, relaxation of these requirements for any reason might constitute a distortion of the legislative scheme.¹¹³

regulatory measure unless they establish that prevention of the plaintiff's injury was a goal of the enacting body. *See, e.g.*, *Cort v. Ash*, 422 U.S. 66, 78 (1975); *Texas & Pacific Ry. Co. v. Rigsby*, 241 U.S. 33, 39 (1916); *see also* *RESTATEMENT (SECOND) OF TORTS* § 874A (1964).

¹⁰⁷ *See supra* note 1 for the cited authorities.

¹⁰⁸ This proposition is suggested by any consideration given, in the process of implying private rights, to whether the plaintiff is "one of the class for whose special benefit the statute was enacted." *Cort*, 422 U.S. at 78 (quoting *Texas & Pacific Ry. Co. v. Rigsby*, 241 U.S. 33 (1916)) (the availability of judicial relief to achieve protection of investors is a necessary supplement to Commission action), *overruled*, *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *see also* *J.J. Case Co. v. Borak*, 377 U.S. 426 (1964).

¹⁰⁹ *See generally* PROSSER & KEETON, *supra* note 24, § 1, at 5-6, § 4, at 20-26; Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1175-76, 1188-91 (1931); Morris, *Rough Justice and Some Utopian Ideas*, 24 ILL. L. REV. 730, 731-36 (1930); Williams, *The Aims of the Law of Tort*, 4 CURRENT LEGAL PROBS. 137, 144-51 (1951).

¹¹⁰ For examples of judicial solicitude for certain defendant activities, *see generally* *Palsgraf v. Long Island R.R.*, 248 N.Y. 339, 162 N.E. 99, *reh'g denied*, 249 N.Y. 511, 164 N.E. 564 (1928); *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928); *Ryan v. New York Cent. R.R. Co.*, 35 N.Y. 210 (1866).

¹¹¹ *See supra* note 108 and the authorities cited therein for some evidence of this compensatory theme in the implication of private rights.

¹¹² Note, however, that the legislature may welcome the courts' assistance in this regard. *See infra* notes 326-27 and accompanying text for a discussion of congressional approval of the federal courts' development of private rights of action under rule 10b-5.

¹¹³ *See infra* notes 363-64 for a discussion of the separation of powers doctrine.

Nonetheless, this challenge/distortion argument loses power upon consideration of two significant factors. First, in some circumstances the legislature has indicated that it does not intend to preempt the area in which it has acted.¹¹⁴ Second, modern federal doctrine premises implication of private rights upon a finding of a legislative intent that such rights exist.¹¹⁵ Presumably, this intent could extend to both the noncompensatory and compensatory effects of private enforcement. It is one argument of this article that this legislative mindset definitely prevails in the federal securities context. It is a further argument that a legitimate source for divining legislative intent regarding any given implied private right is the shape of the roughly analogous private rights that Congress expressly has provided.

III. PRIVATE RIGHTS OF ACTION FOR MISREPRESENTATION OR OMISSION UNDER THE FEDERAL SECURITIES LAW

A. *Express Rights*

In enacting the '33 and '34 Acts, the United States Congress sought to promote full disclosure and integrity in the marketplace.¹¹⁶ To attain these goals, Congress required certain behaviors,

¹¹⁴ See, e.g., section 16 of the '33 Act, which stipulates that "[t]he rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 77p (1988). Section 28(a) of the '34 Act contains a parallel provision. 15 U.S.C. § 78bb(a) (1988). Moreover, in some cases, the legislature has issued specific calls for additional enforcement by way of private rights. This is the case, for instance, where the '34 Act is violated through insider trading. See *infra* notes 319-33 and accompanying text.

¹¹⁵ See *supra* note 103 and accompanying text.

¹¹⁶ The Supreme Court has "repeatedly . . . described the 'fundamental purpose' of the ['34] Act as implementing a 'philosophy of full disclosure.'" *Basic v. Levinson, Inc.*, 485 U.S. 224, 230 (1988) (quoting *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977)); see also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). The Court also has said that "[t]he primary objective of the federal securities laws [is] protection of the investing public and the national economy through the promotion of a high standard of business ethics . . . in every facet of the securities industry." *Capital Gains Research Bureau*, 375 U.S. at 186-87, cited in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315 (1985). The goals of the federal securities acts most frequently identified by commentators are protection of the investing public from fraud and overreaching, improving investor confidence in the securities markets, promoting the efficient allocation of investment funds by enhancing the supply of publicly available information, and discouraging such improper practices as management self-dealing and insider trading. See, e.g., Brudney, *supra* note 86, at 334-36. Brudney argues that concern with economic allocation is associated primarily with mandated disclosure, whereas concern with fairness is reflected in restrictions on fraud. See *id.* at 333-39.

such as registration of securities and broker-dealers and the filing of various reports,¹¹⁷ and prohibited others, such as engaging in deceptive or manipulative practices.¹¹⁸ Typically, Congress called for or precluded these behaviors without reference to any "result" requirement;¹¹⁹ that is, it imposed legal consequences on certain acts or failures to act regardless of whether a particular undesirable occurrence followed in any given instance.

In some cases, Congress saw fit to make accrual of a private right of action the express consequence of particular regulated behaviors. A "result" in terms of injury to the private party was not necessarily made a condition of the recovery.¹²⁰ In some circumstances, however, the occurrence of plaintiff loss was either made,¹²¹ or permitted to be made,¹²² an issue. This article next discusses the broad parameters and causal requisites of each of the expressly articulated private rights of action based on misrepresentation.

1. Section 11 of the '33 Act

a. *Generally*

Section 11 of the '33 Act¹²³ permits the purchaser¹²⁴ of a security registered pursuant to a registration statement¹²⁵ that contains a material misrepresentation or omission unknown to such purchaser¹²⁶ to sue specified persons associated with the preparation

¹¹⁷ See section 5 of the '33 Act, 15 U.S.C. § 773 (1988); section 13 of the '34 Act, 15 U.S.C. § 78m (1988); section 15 of the '34 Act, 15 U.S.C. § 78o (1988).

¹¹⁸ See section 17 of the '33 Act, 15 U.S.C. § 77q (1988); section 9 of the '34 Act, 15 U.S.C. § 78i (1988); section 10 of the '34 Act, 15 U.S.C. § 78j (1988).

¹¹⁹ Section 9(e) of the '34 Act, 15 U.S.C. § 78i(e) (1988), constitutes an exception to this statement.

¹²⁰ See *infra* notes 150-78 for a discussion of section 12(2) of the '33 Act. See *supra* note 97 for a brief discussion of section 16(b) of the '34 Act.

¹²¹ See *infra* notes 179-95 for a discussion of section 18(a) of the '34 Act.

¹²² See *infra* notes 123-49 for a discussion of section 11 of the '33 Act.

¹²³ 15 U.S.C. § 77k (1988).

¹²⁴ The statutory reference is to "any person acquiring" the security in question. 15 U.S.C. § 77k(a) (1988).

¹²⁵ Courts have interpreted the language granting standing to any person "acquiring such security" (15 U.S.C. § 77k(a) (1988)) as imposing a strict requirement that the security acquired be traced to the offering covered by the defective registration statement. See, e.g., *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1035 (D. Minn. 1981); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 568 (E.D.N.Y. 1971).

¹²⁶ 15 U.S.C. § 77k(a) (1988). In the case of section 11, the fact that the purchaser "knew of such untruth or omission" is treated as a defense. *Id.*; see L. Loss, *supra* note 103, at 898. Compare the treatment of the plaintiff's knowledge for purposes of section 12(2), *infra* note 153. See also *infra* note 139 for the genesis of the requirement.

of the registration statement.¹²⁷ Such a purchaser may sue for the difference between the price paid for the security and its value at the time of the suit.¹²⁸ Where an issuer's securities enjoy significant trading after issuance, the most difficult proof required of the plaintiff may be that the security he or she acquired is "traceable" to the registration statement.¹²⁹ Provided the plaintiff acquired the traceable security before release of the issuer's earnings statement for a twelve-month period beginning after the date of the registration statement ("the issuer's twelve-month earnings statement"), there need be no showing of reliance on the misrepresentation or omission.¹³⁰ Even where reliance must be shown, there is no requirement that the plaintiff actually have seen the registration statement.¹³¹

Defendants who may be subject to section 11 liability include the issuer of the securities in question, the directors of the issuer, the signers of the registration statement, the underwriters of the securities, and experts named in the registration statement.¹³² Various defenses are available to these parties. For purposes of this article, the most relevant¹³³ ones include proof that the plaintiff

¹²⁷ 15 U.S.C. § 77k(a) (1988).

¹²⁸ According to section 11(e).

The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.

Id. § 77k(e).

¹²⁹ See *supra* note 125; see also T. Hazen, *supra* note 8, at 73 n.15, regarding the use of other rights of action to avoid the tracing requirement.

¹³⁰ 15 U.S.C. § 77k(a) (1988).

¹³¹ The '34 Act added the requirement that reliance be demonstrated where the relevant purchase occurs after the release of the issuer's 12 month earnings statement. Its drafters believed that the '33 Act was too stringent. See 78 CONG. REC. S8668 (daily ed. May 12, 1934) (remarks of Senator Fletcher); see also 3 L. LOSS, *supra* note 11, at 1728.

¹³² See *supra* note 127.

¹³³ The most important defense for non-issuer defendants not referred to in the text is the defense of "due diligence." See generally Folk, *Civil Liabilities Under the Federal Securities*

knew of the misrepresented or omitted matter,¹³⁴ and proof that some part of the decline in the security's value was attributable to a cause other than the misrepresentation or omission.¹³⁵ Moreover, in no event may the maximum amount of damages recovered with respect to any security exceed the price at which it initially was offered to the public.¹³⁶

The bringing of a suit under section 11 is subject to various procedural requirements, at least two of which can be quite significant. These significant requirements are the posting of security, if required by the court,¹³⁷ and the satisfaction of a fairly short statute of limitations.¹³⁸

b. Summary of Causal Elements

Where the plaintiff acquired his or her securities before the release of the issuer's twelve-month earnings statement, there ap-

Acts: The BarChris Case (pts. 1 & 2), 55 VA. L. REV. 1, 199 (1969); Spanner, *Limiting Exposure in the Offering Process*, 20 REV. SEC. & COMM. REG. 59 (1987); Note, *Escott v. BarChris: "Reasonable Investigation" and Prospectus Liability Under Section 11 of the Securities Act of 1933*, 82 HARV. L. REV. 908 (1969).

¹³⁴ See *supra* note 126.

¹³⁵ See *supra* note 128 and text accompanying *infra* notes 140-41. See also Note, *Causation of Damages Under Section 11 of the Securities Act of 1933*, 51 N.Y.U. L. REV. 217, 217-25 (1976) for discussion of the history and operation of this defense, which was added to section 11 by the '34 Act.

¹³⁶ 15 U.S.C. § 77k(e) (1988); see *supra* note 128. Even if the security in question has been bought and sold several times, in theory, this limit should not be exceeded. Early holders will not have been damaged unless they resold at a lower price; the damage of later holders would be reduced by a purchase at this lower price. Instances in which intervening (and non-complaining) holders acquired from an early purchaser selling at a loss, held during a period of increasing market value, and sold to a later purchaser who suffered a large decline should be rare. Moreover, the section 11 defendants presumably would be able to demonstrate that at least some part of the duplicative losses were attributable to market forces or other causes unrelated to the misrepresentation. Section 11(e) also provides:

In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.

15 U.S.C. § 77k(e) (1988).

¹³⁷ Section 11(e), 15 U.S.C. § 77k(e) (1988), also provides for this posting.

¹³⁸ Section 13 of the '33 Act establishes that suits under either section 11 or section 12(2) must be brought within one year after discovery of the relevant untrue statement or omission should have been made by the exercise of reasonable diligence and, in any event, within three years after the security was (in the case of section 11) offered to the public or (in the case of section 12(2)) sold. 15 U.S.C. § 77m (1988). See *infra* text accompanying note 165.

parently is no inquiry into transaction cause unless the defendant attempts to prove the plaintiff's actual knowledge of the alleged misrepresentation. This is a difficult burden in the context of a public market and seems, at most, to reflect concern with avoiding the grossest appearance of windfall, rather than any serious preoccupation with issues of cause.¹³⁹

More importantly, however, the defendant has the discretion to raise the issue of loss causation. The statute itself does not contemplate any demonstration by the plaintiff that he or she would not have entered the transaction "but for" the misrepresentation, even in response to the defendant's evidence on the question of loss causation.¹⁴⁰ This combination has the rough effect, then, of presuming that if the truth had been told the transaction nonetheless would have been consummated at some price, and centering debate on the question of what that price would have been.¹⁴¹ In other words, if raised by the defendant, the critical issue in this situation actually appears to be one of causation of transaction price.¹⁴²

If the plaintiff acquired the relevant securities after release of the issuer's twelve-month earnings statement, he or she will be required to introduce evidence of reliance. In other words, a form of imprecise "but for" causation will be added as an element of the *prima facie* case. It is imprecise because it does not establish whether the plaintiff relied on the misrepresentation or omission in purchasing the security or whether the purchase simply would have transpired at some different price. Moreover, in either case it appears that the defendant may raise the issue of loss causation.

The causal requirements of section 11, then, broadly but clearly indicate several compatible congressional determinations. First, the fact that plaintiffs acquiring securities not long after the release of the defective registration statement need make *no* threshold causal showing suggests a firm belief that misrepresentations in registration statements affect or "cause" transaction prices. Second, the erection of a strong causal presumption favoring the plaintiff dem-

¹³⁹ In fact, legislative history suggests that Congress devised the "knowing plaintiff" defense when section 11 (then designated section 9) provided for suits against "vendors," and intended that the defense simply function to permit innocent intermediate purchasers to resell their securities after disclosure was made. See *Hearings on S. 875 Before the Senate Comm. on Banking and Currency* (April 4, 1933) (statement of Arthur H. Dean), reprinted in ELLENBERGER & MAHER, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933, SENATE HEARINGS 148-52 (1971).

¹⁴⁰ Nonetheless, such a demonstration is not precluded, and might be fruitful.

¹⁴¹ The presumption, however, does not appear to be irrebuttable. See *supra* note 140.

¹⁴² See *supra* text accompanying note 56.

onstrates that section 11 actions are not intended to be strictly compensatory.¹⁴³ Instead, during the period in which transaction prices are most likely to be affected (that is, before release of the issuer's twelve month earning statement), individual purchasers may be characterized as private attorneys general, as well as the persons most likely to have suffered any injury.

The treatment of cause in the section 11 context also conveys information about congressional response to certain of the previously discussed motivations for the development of the requirement of cause. For instance, Congress has shown itself more than willing to intrude on individual autonomy, and none too worried about the other moral implications of cause.¹⁴⁴ At the same time, however, the fact that lack of loss causation may be invoked as a defense suggests concern with limiting liability in some reasonable fashion.¹⁴⁵ This concern is driven home by the imposition of a ceiling on liability based on the price at which the securities in question originally were offered to the public,¹⁴⁶ coupled with the requirement that the plaintiff's securities be traced to the registration statement of which complaint is made.¹⁴⁷ Interestingly, the resulting exposure to liability seems to comport roughly with the economic approach described in Part IIIA(5) above.¹⁴⁸ Thus, the penalty

¹⁴³ See Note, *Causation Under Section 11*, *supra* note 135, at 219; *cf.* *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1285, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173-77 (1933); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 247-53 (1933). Because of the difficulty of disproving cause, even injury-free plaintiffs sometimes may recover.

¹⁴⁴ This conclusion is part-and-parcel of the overall structure of the federal securities law. The individual rights proponent generally would endorse state-enforced restrictions on misrepresentation (an act depriving another of the ability to exercise free will (see *supra* text accompanying note 75)), but presumably would disapprove mandated registration and disclosure. Given the reliance of Congress on these mandates in its general approach to securities regulation, it indeed would be somewhat incongruous for that body to have resorted to libertarian philosophy to resolve interstitial issues.

¹⁴⁵ It also may be a way of charging plaintiffs with market risks ordinarily associated with investment. See *infra* note 215.

¹⁴⁶ Imposition of such a ceiling effectively limits the liability of issuers and underwriters to the amount they received from the sale. By contrast, the liability of other defendants will not be limited by their lack of individual benefit in connection with the sale.

¹⁴⁷ This pattern leads to the tempting conclusion that, in this instance, Congress has adopted something of an "unjust enrichment" approach to liability. This conclusion is accurate only in the grossest sense, however, in view of the limitations (including causal requisites) traditionally imposed on unjust enrichment recoveries. See *infra* notes 282-84 and accompanying text. Moreover, not all defendants under section 11 will have profited personally from the misrepresentation in question. See *supra* note 146.

¹⁴⁸ See *supra* notes 86-88 and accompanying text. This analysis does not purport, however, to account for such factors as the defendant's state of mind. See *supra* note 133 and *infra* note 149.

theoretically imposed equals the gain of some defendants, i.e., issuers and underwriters, from the misrepresentation and exceeds that of others, i.e., directors and signers.¹⁴⁹

2. Section 12(2) of the '33 Act

a. *Generally*

Section 12(2) of the '33 Act¹⁵⁰ grants a right to rescission (or rescissory damages)¹⁵¹ to the purchaser of a security offered or sold by means of a prospectus¹⁵² or oral communication containing a material misrepresentation or omission unknown to such purchaser.¹⁵³ Although the Supreme Court specifically has reserved the issue,¹⁵⁴ the persons against whom suit may be brought likely are the same as those subject to liability under section 12(1).¹⁵⁵ The

¹⁴⁹ This may address the possible "nondetection" problem arising where the activity in question necessarily is concealed. See *supra* note 88 and accompanying text.

One may draw another distinction between actions brought against issuers and those brought against other kinds of defendants. A conduct-related defense is available to the latter group but not to the former. See *supra* note 133. In other words, the issuer is an insurer of the accuracy and completeness of the registration statement but non-issuers are not. The theoretically most difficult actions, then, are likely to be those brought against non-issuers. Thus, Congress appears to have established a scheme in which those most financially interested in the sale of securities (issuers) are given the most substantial incentives to avoid misrepresentations or omissions. Congress has given reduced incentive to an additional group capable of policing the registration process.

At the same time, however, one must examine this "reduced incentive" notion in light of the fact that some potential members of this additional group may not profit personally from a defective sale. In other words, being forced to pay damages when one has not profited probably is a more fearsome prospect than being forced to disgorge all of what one actually has received. This brings into better perspective the importance Congress has given to the integrity of the registration scheme.

¹⁵⁰ 15 U.S.C. § 77i (1988).

¹⁵¹ See *Pinter v. Dahl*, 486 U.S. 622, 641 n.18 (1988) ("Th[e] damages calculation [of section 12] results in what is the substantial equivalent of rescission."); see also *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) (same general effect).

¹⁵² The term "prospectus" is defined in section 2(10) of the '33 Act, 15 U.S.C. § 77b(10) (1988).

¹⁵³ In the case of section 12(2), courts have regarded the purchaser's lack of knowledge as an element of the plaintiff's case. See, e.g., *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034 (2d Cir. 1979); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129-30 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974). See *supra* note 139 for a discussion of the genesis of the knowing plaintiff concept.

¹⁵⁴ *Pinter*, 486 U.S. at 655.

¹⁵⁵ As the Supreme Court noted in *Pinter*, the "offers or sells" and "purchasing such security from him" language governing section 12(1), 15 U.S.C. § 77i(1) (1988), has an identical counterpart in section 12(2), 486 U.S. at 655. Accordingly, most courts and commentators have used the same definition of potential defendants for purposes of both subsections. See, e.g., *Pharo v. Smith*, 621 F.2d 656, 665-68, and nn.6-8 (5th Cir. 1980);

Court recently defined this group as those composed of the previous owner of the security (that is, the individual passing title to the plaintiff) and anyone who solicited the sale in question to further either his or her own, or the seller's, financial interest.¹⁵⁶ The use of this fairly narrow definition effectively imposes on the plaintiff a type of privity requirement.¹⁵⁷

Although reliance is not required by the language of section 12(2),¹⁵⁸ at least one commentator has suggested that the cause of action sounds in fraud, thus mandating proof of reliance.¹⁵⁹ Nonetheless, substantial authority exists that purchasers seeking rescission under section 12(2) need not demonstrate reliance.¹⁶⁰ In fact, where the misrepresentation or omission is contained in a writing and relates to a widely held security, purchasers apparently need not even demonstrate their receipt of the misleading writing.¹⁶¹

Schneider, *Section 12 of The Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective*, 51 TENN. L. REV. 235, 261 & nn.144 & 145 (1984).

¹⁵⁶ *Pinter*, 486 U.S. at 643. For a discussion of the controversy surrounding this issue prior to *Pinter*, see O'Hara *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 UCLA L. REV. 921 (1984).

¹⁵⁷ "Privity of contract" is defined as "[t]hat connection or relationship which exists between two or more contracting parties. It was traditionally essential to the maintenance of an action on any contract that there should subsist such privity between the plaintiff and defendant in respect of the matter sued on." BLACK'S LAW DICTIONARY 1079 (5th ed. 1979). See generally O'Hara, *supra* note 156.

¹⁵⁸ The statute specifies only that the plaintiff must not have known of the misrepresentation or omission. See *supra* note 150.

¹⁵⁹ See T. HAZEN, *supra* note 8, § 7.5, at 204. An attempt might be made to justify this inquiry by reference to the statutory requirement that the sale of the securities in question be "by means of" the communication of which the plaintiff complains. See *supra* note 150 and *infra* text accompanying note 161; cf. Douglas & Bates, *supra* note 143, at 178 n.18. This language occasionally has been said to impose the requirement of some sort of causal relationship between communication and purchase. See, e.g., *Austin v. Loftsgaarden*, 675 F.2d 168, 176 (8th Cir. 1982), *aff'd*, 478 U.S. 647 (1986).

¹⁶⁰ See, e.g., *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034 (2d Cir. 1979); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 924 (8th Cir. 1977); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 696 (5th Cir. 1971); *Gilbert v. Nixon*, 429 F.2d 348, 356-57 (10th Cir. 1970); *John Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129-30 (4th Cir. 1970); see also Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How it Compares with Rule 10b-5*, 13 HOUS. L. REV. 231, 264-65 (1976).

¹⁶¹ See, e.g., *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225-26 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *Demarco v. Edens*, 390 F.2d 836, 840-42 (2d Cir. 1968). This result is confirmed by a relevant House Report:

[A]lthough [statements issued in connection with the sale of securities] may never actually have been seen by the prospective purchaser, because of their wide dissemination, [they] determine the market price of the security which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness

The Supreme Court specifically discussed the extent of the rescissory remedy available under section 12(2) in the 1986 case of *Randall v. Loftsgaarden*.¹⁶² In repulsing a claim that the amount recoverable should be limited by any tax benefits received from ownership of the relevant security, the *Randall* Court noted that in enacting the '33 Act, Congress had broader goals than the reimbursement of particular victims.¹⁶³ Accordingly, the section 12(2) defendant is to bear "the risk of an intervening decline in the value of the security . . . whether or not that decline was actually caused by the fraud."¹⁶⁴ The Court noted that Congress devised this risk to create an additional measure of deterrence as compared to a purely compensatory measure of damages.¹⁶⁵

b. Summary of Causal Elements

Section 12(2) plaintiffs must plead that they did not know of the true state of affairs concealed by the misrepresentations or

to insist upon the assumption of responsibility for the making of these statements.

H.R. REP. NO. 85, 73d Cong., 1st Sess. 10, reprinted in 1933 U.S. CODE CONG. & ADMIN. NEWS (referring to sections 11 and 12 of the '33 Act). See generally Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

Although the causal elements of a suit based on a misrepresentation or omission relating to a security that is not widely held basically track those described in the text, there is one arguable difference. This involves receipt of the communication that is claimed to be defective. Thus, if a misrepresentation is made only to the first of two individual purchasers, and is not communicated to the second, it appears that the sale to the second purchaser does not satisfy the "by means of" requirement imposed by the statutory language. See *supra* note 153. In effect, both transaction and loss causation clearly are lacking in these circumstances. In still other terms, the conclusion that the seller should have no liability to the second purchaser makes sense because the defendant has created a risk of injury only to the first, and thus has breached no duty to the second. The threatened penalty might be excessive if the rule were otherwise. Moreover, once having misspoken, the seller would have little reason not to repeat the misrepresentation to subsequent purchasers.

¹⁶² 478 U.S. 647, 655-60 (1983).

¹⁶³ *Id.* at 659.

¹⁶⁴ *Id.* (emphasis added).

¹⁶⁵ *Id.* A defendant under section 12(2) can, however, escape liability entirely by "sustain[ing] the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 771(2) (1988). This standard "presumably is somewhat less exacting" than the reasonable investigation standard of section 11. Douglas & Bates, *supra* note 143, at 208 n.205; Comment, "Reasonable Care" in Section 12(2) of the Securities Act of 1933, 48 U. CHI. L. REV. 372, 387-92 (1981). For suggestions that the standards are similar or that the standard enunciated by section 12(2) is the stricter, see, respectively, Folk, *supra* note 133, at 207-15, and Kaminsky, *supra* note 160, at 275-78. In addition, the section 12(2) cause of action is subject to the same short statute of limitations applicable to actions brought under section 11. See *supra* note 138.

omissions on which suits are based.¹⁶⁶ Nonetheless, exclusion of those who knew of the misrepresented or omitted matter from the class of plaintiffs does not establish serious interest in cause.¹⁶⁷ After all, where the misrepresentation or omission is addressed either directly to the plaintiffs or to a public market in which the security in question is traded, there most likely will be no inquiry into transaction causation.¹⁶⁸ Similarly, no opportunity arises for the defendant to raise the subject of loss causation. If the misrepresentation or omission was made, and the plaintiffs did not know the truth, defendants in privity (as defined above) will be liable for rescission or rescissory damages,¹⁶⁹ broadly calculated in light of *Randall v. Loftsgaarden*.¹⁷⁰

From the face of section 12(2), it appears, then, that Congress hoped to impose fairly certain liability on those defendants who financially benefit from transactions involving misrepresentations or omissions.¹⁷¹ In such circumstances, it is the rescission measure, along with the modified privity requirement, that brings such liability within reasonable limits.¹⁷² The fact that loss causation is never permitted to be raised as an issue makes it even clearer than in the

¹⁶⁶ See *supra* note 153 and accompanying text; see also, e.g., *Mayer v. Oil Field Systems Corp.*, 803 F.2d 749, 755 (2d Cir. 1986) (plaintiff who knew of the matter omitted cannot recover under section 12(2)).

¹⁶⁷ See *supra* note 139 for a description of the genesis of the "knowing plaintiff" concept at a time when section 12 had not been separated from section 11 and their common predecessor (draft section 9) contemplated suits against "vendors."

From the strict economic viewpoint, it would seem that the willingness of an individual to purchase in the face of actual knowledge reflects a conscious assumption of risk for which a price concession could be demanded. If such a demand is not made, the purchaser presumably has some reason. Thus, there is no coerced transfer of wealth. Moreover, assuming that the knowledge of the purchaser is incidental and not foreseen by the seller making a misrepresentation, deterrence values would not seem to require imposition of liability. In other words, the happenstance of the knowing purchaser and resultant nonliability is sufficiently unlikely that it would not affect the seller's planning. Nonetheless, because there is apt to be a shortfall in detecting activities involving concealment, imposition of liability in this situation is justifiable. See *supra* text accompanying notes 87-88.

¹⁶⁸ See *supra* note 160. In these circumstances, no sound reason exists to distinguish oral and written communications, assuming that the communication in question is addressed to the market.

¹⁶⁹ This assumes, of course, that other applicable defenses, such as reasonable care, are unavailable. See *supra* note 165.

¹⁷⁰ See *supra* notes 162-65 and accompanying text; see also *infra* notes 270-84 and accompanying text for discussion of rescissory damages in the rule 10b-5 context.

¹⁷¹ This again assumes that the defendants in question are unable to demonstrate their reasonable care. See O'Hara, *supra* note 156, at 973, 1001-02.

¹⁷² This function, then, parallels that of the tracing and other requirements under section 11. See *supra* notes 146-47 and accompanying text.

case of section 11 that the cause of action is not primarily compensatory.¹⁷³ Thus, deterrence is the logical, and acknowledged,¹⁷⁴ congressional goal; its method of accomplishment is imposition of a penalty that sometimes theoretically will equal¹⁷⁵ but sometimes will exceed¹⁷⁶ the defendant's gain from any misrepresentation.¹⁷⁷ This amount¹⁷⁸ is to be collected by a private attorney general who, not coincidentally, also happens to be the individual most likely to have suffered any injury the defendant's wrongful act may have caused.

3. Section 18(a) of the '34 Act

a. *Generally*

Under section 18(a) of the '34 Act,¹⁷⁹ persons purchasing or selling securities at a "price affected" by a false or misleading statement¹⁸⁰ contained in a document filed with the SEC under the

¹⁷³ *But see* Douglas & Bates, *supra* note 143, at 177 ("The remedy under section 12(2) . . . is probably compensatory.")

¹⁷⁴ See *supra* notes 162-65 and accompanying text.

¹⁷⁵ This would be the case where the plaintiff seeks rescission and returns to the defendant a security with all residual value other than that attributable to the misrepresentation.

¹⁷⁶ This would be the case where, for instance, there has been an interim decline in the value of the security not attributable to the misrepresentation.

¹⁷⁷ Where a defendant seller's gain will include some profit not related to the misrepresentation, *e.g.*, some previously accumulated increase in value, this amount may be returned to the defendant upon rescission or accounted for in calculating rescissory damages. *But see supra* notes 162-65 and accompanying text.

¹⁷⁸ See *supra* text accompanying notes 87-88 and *supra* note 177 for a discussion of the economic desirability of this measure.

¹⁷⁹ Section 18(a), in relevant part, reads as follows:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, *in reliance upon such statement*, shall have purchased or sold a security *at a price which was affected by such statement, for damages caused by such reliance*, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r(a) (1988) (emphasis added).

¹⁸⁰ Although, as proposed, the section specifically referred to omissions, this reference was deleted in conference "as surplusage in view of the fact that a statement obviously may be misleading because of a material omission." H.R. REP. NO. 1838, 73d Cong., 2d Sess. 36, *reprinted in* 1934 U.S. CODE CONG. & ADMIN. NEWS.

'34 Act may recover for damages caused by their reliance. In contrast to the express rights granted under the '33 Act, the reliance requirements under section 18 are quite strict. In fact, courts typically require satisfaction of the "eyeball test"—the party seeking recovery must demonstrate that he or she actually read either the original or a copy of the filed document.¹⁸¹ As commentators have noted, however, few participants in modern securities markets themselves read filings with the SEC; they instead rely either on information disseminated by professional analysts (who may or may not themselves become purchasers or sellers) or simply on market movements.¹⁸² Accordingly, actions under section 18(a) are scarce, and in no reported case has the plaintiff obtained a recovery.¹⁸³

The utility of such actions is even further reduced due to the strict causal showing thought to be required by the statute's "price affected" wording.¹⁸⁴ Courts have construed this wording as placing a burden on the plaintiff to demonstrate a causal connection between the misrepresentation or omission in question and the security's movement in price.¹⁸⁵

Persons who may be sued under section 18(a) include the issuer or other person filing the document, as well as "any person who shall make or cause to be made" the relevant misrepresentation or omission.¹⁸⁶ This language indicates that liability may be imposed on any of the issuer's officers or directors who sign the filed documents,¹⁸⁷ and may extend to other officers and directors as well.

¹⁸¹ See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977).

¹⁸² See Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1359-60 (1966); Note, *Section 18 of the Securities Exchange Act of 1934: Putting the Bite Back into the Toothless Tiger*, 47 FORDHAM L. REV. 115, 116 (1978).

¹⁸³ See M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 5.04[2] (1988); Steinberg, *The Propriety and Scope of Cumulative Remedies Under The Federal Securities Laws*, 67 CORNELL L. REV. 557, 579-80 (1982).

¹⁸⁴ See *supra* note 179.

¹⁸⁵ See *Hoover v. Allen*, 241 F. Supp. 213, 223-25 (S.D.N.Y. 1965); cf. *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1157 (5th Cir. 1982) (same question in context of section 9(e) of the '34 Act, 15 U.S.C. § 78i(e) (1988)).

¹⁸⁶ See *supra* note 179.

¹⁸⁷ The imposition of liability upon signatories is particularly important now that a majority of the board of directors is required to sign the issuer's Annual Report on Form 10-K. See *General Instruction D(2)(a) to Form 10-K, SEC Securities Act Release No. 6231*, Sec. Reg. & L. Rep. (BNA) No. 569, at SS-3 (Sept. 10, 1980); see also M. Steinberg, *supra* note 183, § 5.04[3].

There is no requirement that the plaintiff have had any transaction with the issuer or other defendant.¹⁸⁸

b. *Summary of Causal Elements*

Suits under section 18(a) are subject to causal demonstrations at least as strict as those typically required at common law.¹⁸⁹ In contrast to sections 11 and 12(2), both a type of transaction causation and loss causation are made elements of the plaintiff's case. This variation in rigor suggests at least two possible conclusions. The first is that because there is no requirement of privity or other ready method of capping potential liability, cause simply may be intended to play a role in bringing potential liability within acceptable bounds.¹⁹⁰ If such limits were not in place, issuers might be subject to overdeterrence in registering securities under the '34 Act and making disclosure in the required reports. One way in which this overdeterrence might be manifested is excessive caution and expenditure in preparing filings.

A second possible conclusion is that section 18(a) suits are not particularly favored relative to the '33 Act private rights,¹⁹¹ and were designed solely to recognize the plaintiff's moral claim to compensation. Such an explanation is plausible if one believes either that truth in distributing securities (addressed by section 11 and section 12(2)) is more important than truth in the documents intended to support the after-market¹⁹² or that there is substantially

¹⁸⁸ Available defenses include the defendant's proof that "he acted in good faith and had no knowledge that such statement was false or misleading." See *supra* note 179. This formulation presumably contemplates a lesser standard than either the "due diligence" defense of section 11 or the "reasonable care" defense of section 12(2). See *supra* notes 133 and 165. Moreover, actions under section 18(a), like those under sections 11 and 12(2), are subject to a short statute of limitations: Section 18(c) provides that suit must be brought within one year of discovery of the relevant facts and within three years of the accrual of the cause of action. 15 U.S.C. § 78r(c) (1988). Another important procedural limitation is that a court in its discretion may award both court costs and attorneys' fees against either party. *Id.* § 78r(a).

¹⁸⁹ See generally Part IIA above.

¹⁹⁰ As initially introduced, section 18(a) (then section 17(a)) contained a damage measure that could have led to fairly extensive levels of liability. This measure was the difference between the price paid by the plaintiff and the lowest market price within 90 days of the purchase. S. 2693, 73rd Cong., 2d Sess. § 17(a) (1934).

¹⁹¹ This conclusion also might be suggested by the relatively lower standard of care required to establish a defense under section 18(a). See *supra* note 179.

¹⁹² A related explanation couched in economic terms is that any loss to traders caused by defective '34 Act filings will be offset by gains to other traders. In other words, no serious misallocation problems will result. Net societal losses presumably will be limited to the mechanical making of the misrepresentation and the duplicative search costs stimulated if

more incentive for sellers to mislead purchasers than for issuers and their agents to misinform the market generally.

In evaluating these arguments, however, it should be noted that section 12(2) literally does apply in after-markets as well as in distributions.¹⁹³ Moreover, the adoption of the '34 Act itself stands as recognition that capital formation and investor confidence goals could not be attained without a safe after-market.¹⁹⁴ Thus, the argument based on concern with type of market is not particularly strong.

The argument based on incentive to mislead may be more attractive but also is ultimately unsatisfactory. In fact, there are significant incentives for issuers to mislead the market.¹⁹⁵ The difference between such incentives for issuers and those for sellers cannot account for the vast difference in strength between the '33 Act rights and the right provided under section 18(a). The most logical explanation, then, is that Congress simply felt a need to cap liability in the section 18(a) context and resorted to the common law concept of cause to do so.

In retrospect, however, the selection of common law cause clearly was ill-suited to the open-market trading injuries that Con-

investors perceive that issuers and their agents may successfully misinform the market. This arguably is a matter of less concern than the misallocation of capital that may be induced where misrepresentation occurs in the initial sale of a security. It is possible, however, that inaccurate aftermarket prices may affect the price of future initial offerings and the willingness of lenders to make capital available.

¹⁹³ This is true despite the emphasis of '33 Act regulation on the initial placement process. *Cf.* *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (viewing application of section 17(a) of the '33 Act to the after market as a "major departure" from the '33 Act's primary concern "with the regulation of new offerings"). A few lower courts, in disregard of the language of the statute, have declined to apply section 12(2) to the after market. *See, e.g., Strong v. Paine Webber, Inc.*, [1988-89 Transfer Binder] (CCH) Fed. Sec. L. Rep. ¶ 94, 053 (S.D.N.Y. 1988); *Ralph v. Prudential-Bache Securities, Inc.*, [1988-89 Transfer Binder] (CCH) Fed. Sec. L. Rep. ¶ 93, 964 (S.D. Fla. 1988); *see also* M. Steinberg, *supra* note 183, § 6.02[1]. The Supreme Court, however, has not squarely addressed this issue. *Compare* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.27 (1976) (suggesting section 12(2) may not be limited to distribution process), *with* *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 728, 753 (1975) (suggesting purchaser's right to sue under section 12(2) may be limited to context of initial distribution).

¹⁹⁴ *See supra* note 116 and accompanying text.

¹⁹⁵ Consider, for instance, the incentive for management to deny untruthfully the existence of preliminary merger negotiations. *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224, 227-28 (1988); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). Consider also the facts of the landmark case *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In *Texas Gulf Sulphur Co.*, the issuer sought to maintain the secrecy of a major mineral discovery in order to protect the ability to acquire surrounding mineral-bearing properties and later issued a misleading press release intended to quell a disorderly market. *Id.* at 843-47.

gress intended section 18(a) to redress. It was an "overkill" response to the need to limit the defendant's liability. Given that no plaintiff has recovered under section 18(a), the section 18(a) cause of action apparently has minimal deterrent or other effect. In effect, section 18(a) has been a failure.

4. Section 29(b) of the '34 Act

Although section 29(b) of the '34 Act¹⁹⁶ does not confer a private right of action as explicitly as the provisions previously discussed, courts have reasoned that Congress clearly intended that such a private right exists. Because section 29(b) provides that transactions entered into in violation of the '34 Act, or otherwise involving such a violation, shall be void as to the violators, courts have concluded that the power to avoid must lie in the hands of the wronged parties.¹⁹⁷ Were this not the case, and were the power to avoid in the hands of the SEC, such transactions presumably would have been labeled void in their entirety, not merely as to the wrongdoers.¹⁹⁸

Despite the federal courts' relatively uniform conclusion that section 29(b) does confer a private right, intrajudicial dispute has arisen about the extent of such right. Some courts construe the section literally as granting an innocent party the right to avoid,

¹⁹⁶ Section 29(b) provides, in relevant part, as follows:

Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation

15 U.S.C. § 78cc(b) (1988).

¹⁹⁷ See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735 (1975); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387 (1970); *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 726 (8th Cir. 1977). According to the *Mills* Court, "[t]he interests of the victim are sufficiently protected by giving him the right to rescind; to regard the contract as void where he has not invoked that right would only create the possibility of hardships to him or others without necessarily advancing the statutory policy of disclosure." 396 U.S. at 388.

¹⁹⁸ See *supra* note 197 for the cited authorities; see also Gruenbaum & Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1, 9 (1989).

and thus to rescind, any contract involving another party's violation of the '34 Act.¹⁹⁹ Others regard this construction as "Draconian,"²⁰⁰ and contend that section 29(b) is interpreted more properly as incorporating state common law regarding illegal contracts.²⁰¹ Commentators have strenuously criticized this latter view on the grounds that it disregards the clear language and meaning of the statute and that "[i]f [the] consequences are too harsh on any party, the legislature, not the courts, must change the statute."²⁰²

Under either view, courts apparently require a showing of privity between violator and innocent party before granting a remedy.²⁰³ They do not strictly require, however, an injury to the innocent party or, indeed, any particular consequence of the violation in question.²⁰⁴ Nonetheless, courts regard whatever remedy is available as equitable in nature,²⁰⁵ and therefore, without any prompting from the statute, may make equitable adjustments in the recovery

¹⁹⁹ See, e.g., *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357, 362 (5th Cir.), cert. denied, 393 U.S. 913 (1968); *Myzel v. Fields*, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Marrero v. Banco di Roma (Chicago)*, 487 F. Supp. 568, 578 (E.D. La. 1980).

²⁰⁰ *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1149 (2d Cir. 1970) (Friendly, J., dissenting), cert. denied, 401 U.S. 1013 (1971); see *Occidental Life Ins. Co. v. Pat Ryan & Assoc.*, 496 F.2d 1255, 1265 (4th Cir.) (using the term "devastating"), cert. denied, 419 U.S. 1023 (1974).

²⁰¹ E.g., *Occidental Life*, 496 F.2d at 1255-66; *Pearlstein*, 429 F.2d at 1149 (Friendly, J., dissenting); *Gannett Co. v. Register Publishing Co.*, 428 F. Supp. 818, 831 (D. Conn. 1977); *Freeman v. Marine Midland Bank—New York*, 419 F. Supp. 440, 453 (E.D.N.Y. 1976). Under this approach, a decision that a contract is void presumably would require an assessment of such factors as seriousness of the particular wrongdoing and the public policies implicated by the particular case. See, e.g., *Northern Indiana Public Service Co. v. Carbon County Coal Co.*, 799 F.2d 265, 273-74 (7th Cir. 1986); RESTATEMENT (SECOND) CONTRACTS § 178 (1979).

²⁰² *Gruenbaum & Steinberg*, *supra* note 198, at 17; see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975).

²⁰³ See, e.g., *Thomas v. Duralite Co.*, 524 F.2d 577, 590 (3d Cir. 1975); *Eastside Church*, 391 F.2d at 363; *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 792 (8th Cir. 1967). The concept may be expanded where the complaining party has acquired rights as an assignee, see, e.g., *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 726 (8th Cir. 1974), cert. denied, 419 U.S. 1107 (1975), or third-party beneficiary, see 3 L. Loss, *supra* note 11, at 1759, or where the complaining party is suing derivatively, see, e.g., *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 805-06 (3d Cir. 1949); *Kaminsky v. Abrams*, 281 F. Supp. 501, 507 (S.D.N.Y. 1968). But see *Gruenbaum & Steinberg*, *supra* note 198, at 33-34, for an argument that the privity requirement should be followed only when application furthers the purposes of the '34 Act.

²⁰⁴ *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 522, 559 (5th Cir. 1982). This is similar to the common law or equitable action for rescission, which does not require any showing of damage. See, e.g., L. Loss, *supra* note 103, at 873, 941; see also RESTATEMENT OF RESTITUTION § 1, comment e (1936).

²⁰⁵ See, e.g., *Occidental Life*, 496 F.2d at 1265-66; *Freeman*, 419 F. Supp. at 453.

ultimately granted.²⁰⁶ These adjustments could mean that the rescissory damages actually awarded will equal compensatory damages in some circumstances.²⁰⁷ The propensity to make such adjustments, however, should be reduced by the Supreme Court's recognition in *Randall v. Loftsgaarden*²⁰⁸ that rescissory remedies legitimately may exceed the plaintiff's loss in order to serve a deterrent function.²⁰⁹

In summary, although privity apparently is regarded as an element of section 29(b), cause is not. Section 29(b) thus poses a ready analogue to section 12(2), discussed above.²¹⁰ Its causal elements therefore need not be separately addressed.

5. Summary of the Express Private Rights for Misrepresentation

A pattern present in both the '33 and '34 Acts thus begins to emerge. Generally, plaintiffs in some forms of privity may rescind, without causal showing, those transactions involving the defendants' violation of one of the federal securities acts. In addition, certain causes of action exist without reference to privity but with differing causal requirements. The use of varying formulations strongly suggests that the drafters assigned no intrinsic value to causal linkage.²¹¹ Attempted explanations based on such factors as respect for defendant autonomy and retribution thus have no particular utility. Rather, the simple fact that these variations exist indicates that where any form of causation is invoked, it is a means to an end. The most plausible end appears to be imposition of manageable limits on potential liability.

²⁰⁶ Thus, for instance, a court might not regard it as equitable to grant restitution when the security has suffered a severe depreciation in market value. See RESTATEMENT OF RESTITUTION §§ 69, 142, especially the caveats and comment c (1936).

²⁰⁷ For instance, this might occur where hedging transactions are possible. See Easterbrook & Fischel, *supra* note 85, at 637-38; see also *infra* notes 278-84 and accompanying discussion for the calculation of rescissory damages in actions brought under rule 10b-5 and the description of other restrictions that may be placed on a plaintiff's ability to rescind.

²⁰⁸ See *supra* notes 162-65 and accompanying text for a description of *Randall* in the section 12(2) context.

²⁰⁹ In fact, the Supreme Court specifically contemplated rescission in the '34 Act context, rejecting an argument that if a rescissory remedy is available under section 10(b) it should be limited by section 28(a)'s statement that plaintiffs under the '34 Act may receive only "actual damages." 478 U.S. 647, 660 (1986).

²¹⁰ See *supra* text accompanying notes 166-78.

²¹¹ The use of varying conduct-related defenses may or may not suggest the same thing. These differences presently are not understood well enough to be an especially fruitful line of inquiry. Nonetheless, it seems that defendant behavior is more intrinsically meaningful than is the requirement of cause. See generally *supra* Part IIA.

More specifically, the express private rights of action for misrepresentation provided by the federal securities acts have important similarities, but also critical differences. These similarities and differences suggest the outline of a coherent scheme for private enforcement and reimbursement of injury.²¹² One rendition of such an outline appears immediately below.

6. Models Based on Types of Presumed Injuries

One generally can describe the shape of misrepresentation remedies discussed thus far in terms of two different types of injury presumed to occur in particular trading contexts. These two types may be characterized by reference to the causal relationships discussed in Part IIA of this article. The variety of such relationships demonstrates, however,²¹³ that causal linkages were not of particular interest to Congress but instead were means to ends.

a. *The Face-to-Face Model—Transaction Causation*

The two explicit private rights most often applicable in the case of misrepresentation or omission in face-to-face settings²¹⁴ are section 12(2) of the '33 Act and section 29(b) of the '34 Act. The intimacy of the context is more or less assured by applicable privity requirements. The granting by each of these sections of a rescission-based remedy has the effect of presuming that the defendant lured the plaintiff into a transaction that would not have taken place at any price had the plaintiff known the truth. In other words, the defendant's act of misrepresentation or omission is treated as the cause of the transaction, and the fact of the transaction is regarded as the plaintiff's redressable injury.

²¹² Some commentators might challenge any claim of a coherent outline. According to Professor Loss, "[t]he inevitable result of this episodic kind of legislation, enacted often in response to crisis, is a great many inconsistencies, a considerable number of both gaps and overlaps, and in general needless complexity in a field of the law that would not make light bedtime reading at best." L. Loss, *supra* note 103, at 38-39. Nonetheless, to the extent that one can either identify or superimpose coherence and consistency, it would seem prudent not to ignore the opportunity to do so.

²¹³ See *supra* note 211 and accompanying text.

²¹⁴ Note that a face-to-face context does not necessarily imply that the transaction would have qualified as a private placement, exempt from the '33 Act's registration requirements by reason of section 4(2). 15 U.S.C. § 77d(2) (1988).

b. *The Open-Market Model—Transaction Price Causation*

Section 11 of the '33 Act and section 18(a) of the '34 Act are the provisions most likely to be invoked in connection with trading in the open market. These two provisions either invite or demand focus on the issue of loss causation. This focus suggests that a transaction in the security in question would have taken place at some price, even had the truth been known.²¹⁵

It is crucial to note, however, that although injuries redressable under section 18(a) seem to be regarded as a function of the causation of transaction price, nothing is presumed about the causal linkage itself. Both transaction and loss causation are made elements of the plaintiff's case. In contrast, plaintiffs suing under section 11 who acquired their securities before the release of the issuer's twelve-month earnings statement are granted an irrebuttable presumption of transaction causation and, in effect, a rebuttable presumption of loss causation.²¹⁶ This distinction evidently is based on the fact that there is a tracing requirement and a limit on total damages under section 11; section 18(a) provides no theoretical equivalents. Nonetheless, in light of section 18(a)'s failure as a viable remedy, it appears that the section 11 approach to cause must provide the preferred model, presumably accompanied by recognition that additional forms of limitation on liability may be appropriate in some circumstances.

B. *Implied Rights*

1. Rule 10b-5 Under the '34 Act

a. *Generally*

The implied rights arising under the regulations to rule 10b-5,²¹⁷ which Congress promulgated pursuant to section 10(b) of the

²¹⁵ This treatment often is justified by reasoning that the plaintiffs have shown themselves willing to invest on the open market. Even had they not purchased the security in question, they might have purchased some other publicly traded security, thereby willingly exposing themselves to general market forces and, quite possibly, industry-specific swings as well. This will not, however, inevitably be the case. See Coffee, *supra* note 85, at 748-49 for an insightful discussion of motives for holding nondiversified securities portfolios and other reasons for investment, including employee loyalty.

²¹⁶ See *supra* notes 192-95 for a discussion of arguments concerning the possible reasons for distinguishing distributions and tradings in the after-market.

²¹⁷ 17 C.F.R. § 240.10b-5 (1987). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any

'34 Act,²¹⁸ are by far the best known of the private rights of action implied under the federal securities laws.²¹⁹ A court recognized the first such right in 1946,²²⁰ during a time when private causes of action were implied more readily than is the case today.²²¹ The existence of this right now is "simply beyond peradventure."²²²

The language of rule 10b-5 broadly prohibits (1) employing any device, scheme, or artifice to defraud, (2) making an untrue

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 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.

Id.

²¹⁸ 15 U.S.C. § 78j (1988).

²¹⁹ Substantial dispute exists as to whether section 17(a) of the '33 Act gives rise to any implied private rights of action. See generally T. Hazen, *supra* note 8, § 13.13 & 1988 Supp.; Scholl & Perkowski, *An Implied Right of Action Under Section 17(a): The Supreme Court Has Said "No," But Is Anybody Listening?*, 36 U. MIAMI L. REV. 41, 45-64 (1981); Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163, 172-85 (1979). Acceptance of any implied private rights under section 17(a), however, seems to be on the decline. See, e.g., *In re Washington Public Power Supply System Securities Litigation*, 823 F.2d 1349, 1354 (9th Cir. 1987); *Deviries v. Prudential-Bache Securities, Inc.*, 805 F.2d 326, 328 (8th Cir. 1986); *Landry v. All American Assurance Co.*, 688 F.2d 381, 389 (5th Cir. 1982); *Frymire v. Peat, Marwick, Mitchell & Co.*, 657 F. Supp. 889, 892-93 (N.D. Ill. 1987); *Leiter v. Kuntz*, 655 F. Supp. 725 (D. Utah 1987). But see, e.g., *Gaff v. FDIC*, 814 F.2d 311, 319 (6th Cir. 1987); *Newcome v. Esrey*, 659 F. Supp. 100, 102 (W.D. Va. 1987); *Federal Sav. & Loan Ins. Corp. v. Shearson-American Express, Inc.*, 658 F. Supp. 1331, 1344 (D.P.R. 1987). This decline parallels a general decline in implication of federal private rights. See generally *supra* note 10 and *infra* note 221 for the cited authorities. Moreover, for purposes relevant to this article, those courts that do recognize such rights apparently structure them more or less along the lines of the rights implied under rule 10b-5. Accordingly, separate discussion of section 17(a) will be omitted from the remainder of this article. Note, however, that the apparent lack of a scienter requirement under section 17(a)(2) and (3) may suggest a distinction regarding need to limit liability. See *Aaron v. SEC*, 446 U.S. 680, 695-96 (1980).

²²⁰ *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

²²¹ See generally Ashford, *supra* note 102; Schnieder, *Implying Private Rights and Remedies Under The Federal Securities Acts*, 62 N.C.L. REV. 853, 863-96 (1984); Ratner, *The Demise of the Implied Private Right of Action in the Supreme Court*, 11 INST. SEC. REG. 289 (1980); McMahon & Rodos, *Judicial Implication of Private Causes of Action: Reappraisal and Retrenchment*, 80 DICK. L. REV. 167, 169-92 (1976); see also *supra* notes 102-103.

²²² *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381 (1983). The Supreme Court first acknowledged the existence of a private right under rule 10b-5 in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). For more complete discussion of the evolution of private rights under rule 10b-5, see, e.g., Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651, 654-55 (1972); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of the Legislative Intent?*, 57 Nw. U.L. REV. 627, 629-42 (1963).

statement of material fact or omitting a statement of material fact necessary to render those statements that are made not misleading, and (3) engaging in any act, practice, or course of business operating as a fraud or deceit in connection with the purchase or sale of a security.²²³ The rule's generality is quite deliberate, as it was adopted as a catchall provision to cover acts and practices that Congress and the SEC had failed to address more specifically.²²⁴ The Supreme Court, however, has specified that rule 10b-5 addresses only situations involving deceit or manipulation²²⁵ and has indicated that manipulation should be understood to involve either misrepresentation or nondisclosure.²²⁶

There are certain other aspects of the private rights of action under rule 10b-5 with respect to which the Supreme Court has acted definitively. The Court has established that private plaintiffs must demonstrate both that they are either purchasers or sellers of securities,²²⁷ and that the defendants acted with scienter.²²⁸ The Supreme Court's adoption of this latter requirement arose in part from the perceived need to avoid nullification of the procedural requirements of the express private rights created by sections 11 and 12(2) of the '33 Act.²²⁹ One factor, however, that private plaintiffs need not be concerned with is their privity with the defendants. It is clear, for instance, that an issuer making public misrepresent-

²²³ See *supra* note 218.

²²⁴ See Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW 793, 922 (1967). Of an earlier version of what was to become section 10(b), an administrative spokesperson stated, "[it] says, 'Thou shalt not devise any other cunning devices.'" *Stock Exchange Regulation, Hearings on H. R. 7852 Before the House Comm. on Int'l and For. Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran); see also *Huddleston*, 459 U.S. at 382 (rule 10b-5 is a catchall); *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) (same).

²²⁵ See *Santa Fe Indus. v. Green*, 430 U.S. 462, 476-77 (1972).

²²⁶ See *id.*; see also *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 7-8 (1985) ("manipulative" as used in section 14(e) of the '34 Act, 15 U.S.C. § 78n(e) (1982), requires misrepresentation or nondisclosure); *Chiarella*, 445 U.S. at 235 (limiting liability for nondisclosure to situations where duty to disclose exists).

²²⁷ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975).

²²⁸ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1977); see also *Aaron v. SEC*, 446 U.S. 680, 695-96 (1980) (imposing scienter requirement in SEC enforcement actions). As recognized by the Supreme Court in these cases, scienter is, at least, a state of mind more culpable than negligence. Lower federal courts have struggled with whether reckless conduct by a defendant is sufficient to constitute scienter. See generally Metzger & Heintz, *Hochfelder's Progeny: Implications for the Auditor*, 63 MINN. L. REV. 79, 90-112 (1978) (discussing the circuit courts' attempts to define scienter after *Hochfelder*); Note, *Recklessness Under Section 10(b): Weathering the Hochfelder Storm*, 8 RUT.-CAM. L.J. 325, 349-51 (1977) (examining post-*Hochfelder* judicial treatment of the recklessness standard).

²²⁹ *Hochfelder*, 425 U.S. at 208-11.

tations may be liable to persons purchasing or selling securities in the after-market and having no transaction with the issuer whatsoever.²³⁰

There are a number of questions regarding private actions under rule 10b-5 that remain unsettled. Some of these arise in connection with particular applications of the rule and are discussed below.²³¹ Others are more general. For example, considerable attention recently has focused on the statute of limitations applicable for purposes of rule 10b-5. Despite a fairly long tradition of looking to state law to resolve this issue,²³² a few recent cases have relied on the statutes of limitation applying to analogous express rights existing under the federal securities law.²³³ Accordingly, a distinct split of authority on this issue now awaits eventual resolution by the Supreme Court.

i. The Duty Not to Mislead

The language of rule 10b-5(2) clearly imposes a duty to refrain from making untrue statements of material fact and to disclose any fact necessary to render a statement not misleading.²³⁴ Quite simply,

²³⁰ Cf., e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988).

²³¹ See *infra* text accompanying notes 256-61.

²³² See, e.g., *Hochfelder*, 425 U.S. at 210 n.29 (dictum); *Norris v. Wirtz*, 818 F.2d 1329, 1333 (7th Cir.), *cert. denied*, 484 U.S. 943 (1987); *O'Hara v. Kovens*, 625 F.2d 15, 17 (4th Cir. 1980), *cert. denied*, 449 U.S. 1124 (1981); *Roberts v. Magnetic Metals Co.*, 611 F.2d 450, 452 (3d Cir. 1979); *Nickels v. Koehler Management Corp.*, 541 F.2d 611, 614-15 (6th Cir. 1976), *cert. denied*, 429 U.S. 1075 (1977); *Premier Indus. v. Delaware Valley Fin. Corp.*, 185 F. Supp. 694, 696 (E.D. Pa. 1960). See generally L. Loss, *supra* note 103, at 993-96; Brodsky, *Statutes of Limitations*, 12 REV. SEC. REG. 909 (1979); Martin, *Statutes of Limitation in 10b-5 Actions: Which State Statute is Applicable?*, 29 BUS. LAW 443, 455 n.91 (1974); Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635, 638-43 (1967).

²³³ See, e.g., *Hill v. Equitable Trust Co.*, 851 F.2d 691, 697-98 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 791 (1989); *In re Data Access Systems Sec. Litig.*, 843 F.2d 1537, 1545 (3d Cir.), *cert. denied*, 109 S. Ct. 131 (1988); cf. *Zigel v. Garcia*, [1988-89 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 44,374 (D.C. Md. 1988) (alternative grounds for decision). See *supra* note 232 for commentators' approval of the common sense and logic of this approach.

Outside the securities context, the Supreme Court has indicated that state statutes of limitation need not be "mechanically applied . . . simply because a limitations period is absent from the federal statute." *Occidental Life Ins. Co. v. Equal Employment Opportunity Commission*, 432 U.S. 355, 367 (1977). In *Occidental Life*, the Court stated that "[i]t is the duty of the federal courts to assure that the importation of state law will not frustrate or interfere with the implementation of national policies." *Id.*; see also *DelCostello v. International Brotherhood of Teamsters*, 402 U.S. 151, 169-71 (1983); *International Union, United Automobile Workers of America v. Hoosier Cardinal Corp.*, 383 U.S. 696, 707 n.9 (1966); *McAllister v. Magnolia Petroleum Co.*, 357 U.S. 221, 224 (1958).

²³⁴ 17 C.F.R. § 240-10b-5(b) (1987). See *supra* note 218.

if a disclosure is made, it must be both accurate and complete in all material respects. Moreover, courts have held in certain circumstances that failure to speak where some duty exists to do so is actionable, presumably under other parts of rule 10b-5.²³⁵

Courts frequently assert that in a rule 10b-5 action based on untrue statements, a private plaintiff must show that, in connection with the purchase or sale of a security, the defendant (1) with scienter, (2) made a false representation of (3) a material fact, (4) upon which the plaintiff justifiably relied (5) to his or her detriment.²³⁶ Although not determinative,²³⁷ the common law tort of fraud has provided the basic model for the development of these elements.²³⁸

The elements of a cause of action premised on nondisclosure roughly parallel those of an action based on an affirmative misrepresentation. The most significant difference has been the result of a Supreme Court pronouncement in 1972. In *Affiliated Ute Citizens v. United States*,²³⁹ the Court ruled that where circumstances primarily involve a failure to disclose, "positive proof of reliance is not a prerequisite to recovery."²⁴⁰ The Court further noted that "[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. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."²⁴¹ There has been some dispute as to whether this ruling encompasses all cases primarily involving nondisclosure or is limited to circumstances, like those of *Affiliated Ute*, involving

²³⁵ This article refers to all of these requirements as the "duty not to mislead." See *infra* notes 251-61 for a discussion of one specialized set of circumstances involving the duty to disclose or refrain from trading.

²³⁶ See, e.g., *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983); *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 694 (10th Cir. 1976) (en banc), *cert. denied*, 430 U.S. 955 (1977). Some courts require that the plaintiff establish the justifiability of reliance as a separate element. See, e.g., *Dupuy*, 551 F.2d at 1014; cf. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1121-22 (5th Cir. 1980).

²³⁷ See Note, *supra* note 11, at 585 n.7 (quoting 3 L. Loss, *supra* note 11, at 1435 to the effect that "the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit").

²³⁸ See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975); *Dupuy*, 551 F.2d at 1018; *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Wheeler, *supra* note 11, at 575; Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 828-32 (1965).

²³⁹ 406 U.S. 128 (1972).

²⁴⁰ *Id.* at 153-54.

²⁴¹ *Id.*

nondisclosure by a party upon whom the plaintiff generally relied.²⁴² The former interpretation, however, has been more popular.²⁴³

The recent case of *Basic, Inc. v. Levinson* rectified some part of the suggested schism between actions based on nondisclosure and those based on affirmative misrepresentation.²⁴⁴ In *Levinson*, the Supreme Court held that no error arose in the use of the "fraud-on-the-market" theory.²⁴⁵ This holding established that the burden of demonstrating reliance could be met (that is, that reliance could be presumed) where the private plaintiff showed (1) that the defendant made public misrepresentations, (2) that the misrepresentations would be material to a decision to purchase or sell the relevant shares, (3) that the shares purchased or sold by the plaintiff were traded on an efficient market,²⁴⁶ and (4) that the plaintiff traded

²⁴² See *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749, 756 (11th Cir. 1984) (in order to claim the presumption, plaintiff must demonstrate general reliance); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884-85 (5th Cir. 1973) (same).

²⁴³ See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1973); *Jenkins v. Fidelity Bank*, 365 F. Supp. 1391, 1398 (E.D. Pa. 1973). For evidence of a related dispute, compare *Huddleston v. Herman & MacLean*, 640 F.2d 534, 547-49 (5th Cir. 1981) (necessary to characterize violation as primarily failure to disclose under rule 10b-5(1) or (3)), *aff'd in part and rev'd in part, on other grounds*, 459 U.S. 375 (1983), with *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978) (reliance may be presumed in half-truth case coming within rule 10b-5(2)). For a discussion of these and other approaches, see generally Note, *Reliance*, *supra* note 11.

²⁴⁴ 485 U.S. 224, 249-50 (1988).

²⁴⁵ For commentary on this theory, see, e.g., Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435, 447-57 (1984); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 WASH. & LEE L. REV. 861, 866-93 (1982); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

²⁴⁶ The Supreme Court did not specify the indicia of an efficient market, other than to say "modern securities markets . . . differ from the face to face transactions contemplated by early fraud cases." 485 U.S. at 246. The Court further stated:

We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.

Id. at 246-47 n.24.

Research conducted in support of the thesis that national securities exchanges disseminate information efficiently usually takes one of three forms. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 388 (1970). "Weak form" tests measure whether the market fully reflects historical price data. "Semi-strong form" tests address whether all publicly available information is reflected. "Strong form" tests examine whether both public and nonpublic information are reflected. Tests of the strong form theory have

the shares between the time the misrepresentations were made and the time the truth was revealed.²⁴⁷

Thus, at least in cases involving material misrepresentations released to a public market trading in a particular security, courts may afford private plaintiffs a rebuttable presumption of reliance more or less equivalent to that generally regarded as available in the case of material omissions.²⁴⁸ Apparently, only in situations involving affirmative misrepresentations relating to privately traded securities will the court ritually put the plaintiff to the proof of reliance.²⁴⁹ Nonetheless, even when relaxing the reliance requirement, the Supreme Court has been careful to observe that the requirement has not been abandoned, and that causation-in-fact continues to be a critical concept for purposes of rule 10b-5 jurisprudence.²⁵⁰

ii. The Duty to Disclose or Refrain from Trading

Rule 10b-5's prohibition of fraudulent or deceptive acts or practices precludes certain parties from trading in given securities while in possession of particular types of undisclosed material information relating to those securities.²⁵¹ The prohibition applies to both the issuer of securities²⁵² and "insiders" of the issuer,²⁵³ and

been inconclusive at best. See Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 3 n.9 (1978). In fact, some strong form tests suggest those with inside information trade at an advantage. See Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 4 n.22 (1983).

²⁴⁷ 485 U.S. at 248 n.27.

²⁴⁸ See L. Loss, *supra* note 103, at 962 ("As an alternative to reliance, the ['fraud on the market'] doctrine really adds nothing to Ute's presumption of reliance from materiality in silence cases.")

²⁴⁹ In *Basic, Inc. v. Levinson*, the Court did reaffirm the reliance requirement, saying, "[w]e agree that reliance is an element of a rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury. There is, however, more than one way to demonstrate the causal connection." 495 U.S. at 243 (citations omitted).

²⁵⁰ *Id.*; see also *supra* text accompanying notes 240.

²⁵¹ See T. Hazen, *supra* note 8, § 13.9; A. BROMBERG & D. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 2.6(2) (1967).

²⁵² See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *accord* *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *Kohler v. Kohler Co.*, 319 F.2d 634, 638-39 (7th Cir. 1963); Brudney, *supra* note 86, at 322.

²⁵³ Brudney, *supra* note 86, at 322. An insider is an individual owing a fiduciary duty of loyalty to an issuer's shareholders. *Id.* at 343-44. Subject to certain restrictions, individuals who receive material, nonpublic information from insiders inherit a derivative duty. See *Dirks v. SEC*, 463 U.S. 646, 655 (1983).

also may apply to others in the limited circumstances discussed below. At a minimum, the information regarded as within the interdiction includes those matters relevant to the intrinsic value of the issuer's securities.²⁵⁴ The duty imposed is an alternative one: the individual or entity subject to the duty ("subject party") must either disclose the relevant information to those with whom such subject party will be trading or refrain from making a trade.²⁵⁵

Courts readily have imposed the duty to disclose or refrain from trading upon those individuals or entities who have a fiduciary or similar relationship with parties with whom they seek to trade.²⁵⁶ They have indicated only a limited willingness to extend the duty beyond the traditional group of "insiders." Under a line of argument known as the "misappropriation theory," a person who has misappropriated confidential information in violation of a fiduciary duty owed to one other than the issuer or its shareholders also may be included in the group of subject parties.²⁵⁷ To date, however, the Supreme Court has failed to rule definitively on this theory,²⁵⁸ even in the context of government enforcement. Moreover, lower courts unanimously have declined to apply it in the context of private rights of action.²⁵⁹

²⁵⁴ Brudney, *supra* note 86, at 322. Such information is to be distinguished from that relating to general market influences. *See id.* at 329.

²⁵⁵ *Texas Gulf Sulphur Co.*, 401 F.2d at 848. *But see* Friedman, *Efficient Market Theory and Rule 10b-5 Non-Disclosure Claims: A Proposal for Reconciliation*, 47 MO. L. REV. 745, 750 (1982) (making the claim that abstention from trading is not an appropriate alternative). This article will refer to this duty as the "duty to disclose or refrain from trading."

²⁵⁶ *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 225-30 (1980). The initial applications of the duty to disclose or refrain from trading were based on two rationales. First, trading by insiders was a breach of the fiduciary duty owed to the issuer's shareholders (both those purchasing and those selling shares). *See Cady, Roberts & Co.*, 40 S.E.C. 907, 912 & n.15 (1961). Second, the use for private purposes of confidential information originally intended for corporate purposes was inherently unfair to other investors. *Id.*

²⁵⁷ *See Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting); R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 1050-51 (6th ed. 1987).

²⁵⁸ *See Carpenter v. United States*, 484 U.S. 19, 24 (1987) (Court evenly split on the validity of theory, at least on the facts presented). The Court has mentioned the theory at least three other times without disapproving it. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 313 n.22 (1985); *Dirks v. SEC*, 463 U.S. 646, 665 (1983); *Chiarella*, 445 U.S. at 235-37.

²⁵⁹ *See Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 12 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). Note, however, that recent legislative history relating to a new, explicit private right of action against inside traders has endorsed it wholeheartedly. *See infra* note 328 and accompanying text. In addition, the theory has been approved by lower courts in cases brought by the government. *See United States v. Carpenter*, 791 F.2d 1024, 1029-34 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197, 201-03 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12,

In addition to the issues involved in defining the subject party, more general questions have arisen regarding the circumstances in which a violation of the duty will give rise to a private cause of action. Most significantly, some courts have declined to permit persons trading on a public market to pursue a remedy because they were not able to demonstrate a causal connection between the insider trading and either the fact of their own market activity (i.e. transaction causation) or the price at which it occurred (i.e. transaction price causation).²⁶⁰ Other courts, however, have indicated that private plaintiffs need only establish that they traded contemporaneously with an insider in possession of undisclosed material information, and "need not prove that [they] traded directly with the defendant or that the volume of the defendant's trading somehow induced [the plaintiffs'] trade[s]."²⁶¹

iii. Damages and Rescission

Perhaps the most unsettled aspect of the various private rights of action under rule 10b-5 involves the calculation of damages.²⁶² Although there are a number of variant approaches, the primary methods may be described generally as follows.

The most typical measure has been characterized as the "out-of-pocket" measure.²⁶³ In the case of a violation in connection with the sale of a security, this measure reflects the difference between the price the plaintiff paid for the security and the actual value of what was received. In the case of a violation in connection with a purchase, it represents the difference between the price the plaintiff received and the actual value of what was sold. The measure at-

15-19 (2d Cir. 1981), *cert. denied*, 471 U.S. 863 (1983); *SEC v. Musells*, 578 F. Supp. 425, 437-43 (S.D.N.Y. 1984). See generally Prentice, *The Impact of Dirks on Outsider Trading*, 13 SEC. REG. L.J. 38 (1985).

²⁶⁰ See, e.g., *Fridrich v. Bradford*, 542 F.2d 307, 318-19 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); cf. *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1093 (E.D. Pa. 1974) (failure to prove reliance).

²⁶¹ *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 805 (S.D.N.Y. 1983); see also *Goldman v. Belden*, 754 F.2d 1059, 1068 (2d Cir. 1985); cf. *In re Smith Barney, Harris Upham & Co., Exch. Act Rel. No. 34-21242* [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,656 (Aug. 15, 1984).

²⁶² Cf. *Basic, Inc. v. Levinson*, 485 U.S. 224, 228 (1988) (White, J., dissenting) (discussing the special difficulties of calculating rule 10b-5 damages in an action based on the fraud-on-the-market theory).

²⁶³ Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 356 (1984); see also L. Loss, *supra* note 103, at 1133-34; *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) (*dicta*).

tempts to assess actual value on the day the transaction complained of occurred, and generally excludes future changes.²⁶⁴ This approach clearly has the effect of limiting liability by reference to the notion of loss causation, and, at least in part, may be intended to prohibit the plaintiff from shifting ordinary market risks to the defendant.²⁶⁵ In some cases, however, the value of the security in question at a date subsequent to the original transaction (often the date on which the fact of the misrepresentation is disclosed publicly) is used as the "best evidence" of what the security actually was worth at the earlier time.²⁶⁶

A second general approach to the measure of damages for violations of rule 10b-5 may be combined with the first approach. Thus, a court may permit recovery of additional, "consequential" damages where the plaintiff demonstrates the causal nexus with some certainty.²⁶⁷ These damages might even include market losses after the date of the transaction complained of if the plaintiff can demonstrate that his or her decision to enter the market at all was the "natural, proximate, and foreseeable consequence of defendants' fraud."²⁶⁸ Similarly, where a defendant induces a plaintiff to sell a security that otherwise would have been held throughout a period of increasing market prices, the plaintiff may be entitled to the difference between the sales price and the value of the security as of some later date.²⁶⁹

Based on the foregoing, courts commonly are quite interested in limiting a plaintiff to compensatory damages. On fairly rare occasions, however, they have been relatively more interested in ensuring that a defendant does not benefit from his or her wrong-

²⁶⁴ Thompson, *supra* note 263, at 357.

²⁶⁵ *Id.* at 357-58; *see also, e.g.*, Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983); Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 371-77 (1974).

²⁶⁶ Thompson, *supra* note 263, at 362-63. In still other cases, courts seek to ascertain the value of the security at some reasonable time after the plaintiff's discovery of the misrepresentation, apparently as a means of shifting to the defendant market losses incurred before that point. *See id.* at 364-65. This determination has the effect of partially overcoming the potential unfairness of assuming that a plaintiff will quickly learn of, and respond to, information about prior misrepresentation.

²⁶⁷ *Id.* at 360-61; *cf.* RESTATEMENT (SECOND) OF TORTS § 549(2) (1964).

²⁶⁸ *See* Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978); *see also* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970).

²⁶⁹ *See* Dupuy v. Dupuy, 551 F.2d 1005, 1024-25 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Myzel v. Field, 386 F.2d 718, 744-45 n.23 (8th Cir.), *cert. denied*, 390 U.S. 951 (1968).

doing.²⁷⁰ This has sometimes been the case where the act complained of is a violation of the duty to disclose or refrain from trading. In this situation, the plaintiff may be unable to demonstrate a causal connection between the defendant's violation and any injury the plaintiff has suffered.²⁷¹ Where recovery nonetheless is allowed,²⁷² it most likely is premised on the amount of the defendant's profit from his or her unlawful act.²⁷³ This "unjust enrichment" approach²⁷⁴ sometimes also is endorsed in other circumstances.²⁷⁵

At least some of those courts selecting an "unjust enrichment" measure of recovery make no significant attempt to articulate the reason for their choice.²⁷⁶ Others may depend on the theory that a rescissory action might be available under section 29(b) once viola-

²⁷⁰ See, e.g., *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965), cited approvingly in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) (supporting the proposition that "where the defendant received more than the seller's actual loss . . . damages are the amount of the defendant's profit . . . [T]he accepted rationale . . . is simply that [i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them"); see also *Randall v. Loftsgaarden*, 478 U.S. 647, 654 (1986) (quoting *Affiliated Ute* but declining to decide whether rescission is available under rule 10b-5).

²⁷¹ But see *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235-36 (2d Cir. 1974) (plaintiff's injury was said to be attributable to the defendant's failure to speak).

²⁷² See *id.*; see also *supra* note 261 and accompanying text.

²⁷³ See, e.g., *Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156, 172-73 (2d Cir. 1980). See generally Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 19-38 (1982). This approach typically would require pro-rata of the recovery among those trading contemporaneously with the defendant. See Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 639-40 (1982).

²⁷⁴ See Thompson, *supra* note 263, at 354, for a suggestion that this approach may be based upon the principles of unjust enrichment, "often described under the heading of restitution." See generally G. PALMER, *THE LAW OF RESTITUTION* § 1.1, at 1 (1978).

²⁷⁵ See, e.g., *Thomas v. Duralite*, 524 F.2d 577, 589 (3d Cir. 1975); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 802 n.10 (2d Cir.), cert. denied, 414 U.S. 908 (1973); *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965). See generally Thompson, *supra* note 263.

²⁷⁶ Thus, some courts simply state that a plaintiff suing under rule 10b-5 may seek either rescission or damages. See, e.g., *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); *Crist v. United Underwriters, Ltd.*, 343 F.2d 902, 903-04 (10th Cir. 1965); *Evian v. Connell*, 236 F.2d 447, 453-54 (9th Cir. 1956); *Johns Hopkins Univ. v. Hutton*, 326 F. Supp. 250, 262 (D. Md. 1971), *aff'd in part and rev'd in part*, 488 F.2d 912 (4th Cir. 1973), cert. denied, 416 U.S. 916 (1974). Some courts even have stated—incorrectly—that rescission and restitution is the usual remedy in an action under rule 10b-5. See *John R. Lewis, Inc. v. Newman*, 446 F.2d 800, 805 (5th Cir. 1971). Other courts have suggested that rescission is not available if damages are. See *Gilbert v. Meyer*, 362 F. Supp. 168, 176-77 (S.D.N.Y. 1973).

tion of rule 10b-5 is established.²⁷⁷ Still others simply seem to use unjust enrichment and compensatory measures interchangeably.²⁷⁸ A few courts may reflect this confusion when they apply what one commentator has termed the "tort view of rescission."²⁷⁹ These courts invoke unjust enrichment terminology but refuse to place the plaintiff in a better position than occupied before the transaction was entered.²⁸⁰ In some cases, this approach consciously may have been based on the statement in section 28(a) of the '34 Act that plaintiffs under that Act are limited to actual damages. The Supreme Court has rejected the use of section 28(a) as a limit on rescissory damages,²⁸¹ however, and the "tort view of rescission" thus may be expected to decline.

Nonetheless, other substantial impediments remain for plaintiffs who seek a rescission-based recovery under rule 10b-5. For instance, courts considering such recoveries often inquire into whether the benefit received by the defendant was causally linked to the offense of which the plaintiff complains.²⁸² Further, the plaintiff typically must file suit for rescission promptly after notice of the relevant misrepresentation or omission.²⁸³ Another frequent, but by no means universal, limitation is imposition of a privity requirement.²⁸⁴

²⁷⁷ See *supra* notes 196-209 and accompanying text; see also Merritt, *supra* note 11, at 474 n.14.

²⁷⁸ See, e.g., *Meyers v. Moody*, 693 F.2d 1196, 1215 n.15 (5th Cir. 1982) (consequential damages theory used to affirm award district court had described as rescissory), *cert. denied*, 464 U.S. 920 (1983); see also *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

²⁷⁹ Thompson, *supra* note 263, at 376.

²⁸⁰ See, e.g., *Glick v. Campagna*, 613 F.2d 31, 37 (3d Cir. 1979); see also *Huddleston v. Herman & MacLean*, 640 F.2d 534, 554 (5th Cir. 1981) (citing *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1355 (1976) (Sneed, J., concurring)) ("[Rescission's] purpose is to return the defrauded purchaser to the status quo ante."); *Garnatz*, 559 F.2d at 1361; *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 758-59, 766 (E.D. Va. 1980).

²⁸¹ *Randall v. Loftsgaarden*, 478 U.S. 647, 660 (1986). See *supra* notes 162-65 and 208-09 and accompanying text.

²⁸² See, e.g., *SEC v. Wills*, 472 F. Supp. 1250, 1263 (D.D.C. 1978); see also *SEC v. Galaxy Foods, Inc.*, 417 F. Supp. 1225, 1246 (E.D.N.Y. 1976), *aff'd*, 556 F.2d 559 (2d Cir.), *cert. denied*, 434 U.S. 855 (1977). But see *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186, 193 (6th Cir. 1974).

²⁸³ See, e.g., *Baumel v. Rosen*, 412 F.2d 571, 574 (4th Cir. 1969) (delay of 18 months too long), *cert. denied*, 396 U.S. 1037 (1970); see also *Hickman v. Groesbeck*, 389 F. Supp. 769, 775 (D. Utah 1974); *Johns Hopkins Univ. v. Hutton*, 326 F. Supp. 250, 262-63 (D. Md. 1971), *aff'd in part and rev'd in part*, 488 F.2d 912 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974).

²⁸⁴ See *In re Langhorn Sec. Litig.*, 573 F. Supp. 255, 273 (W.D. Okla. 1983); see also 3 A.

b. *Summary of Causal Elements*

Judicial approaches to the private rights of action under rule 10b-5 manifest confused signals as to the importance of cause. On the one hand, continued interest in reliance as an element of the plaintiff's action for violations of the duty not to mislead represents continued preoccupation with "but for" cause.²⁸⁵ In addition, even where reliance may be presumed, the courts have refused either to abandon formally the element of cause-in-fact or to discuss the need for it in any real depth.²⁸⁶

The usual approach to the calculation of damages also demonstrates a traditional interest in causation. Where emphasis is on the "out-of-pocket" plus "consequential" damage to a plaintiff, the defendant's ultimate liability effectively is limited. Because there is no privity requirement under rule 10b-5, no enumeration of permissible defendants, and no statutory cap on liability, an impulse to limit is understandable. Whether it is necessary in cases where liability would not otherwise be excessive is another question. For example,²⁸⁷ where a misrepresentation or omission occurs in connection with the face-to-face sale of a security, the use of either reliance or damage-related causal limitations does not seem to be

BRIMBERG & L. LOWENFELS, *supra* note 251, § 8.5(513), at 208.3. *But see* Gordon v. Burr, 506 F.2d 1080, 1083-84 (2d Cir. 1974); Kaye v. Fast Food Operators, Inc., 99 F.R.D. 161, 164 (S.D.N.Y. 1983). For other significant restrictions, see Merritt, *supra* note 11, at 475.

²⁸⁵ This approach arguably camouflages an interest in monitoring plaintiff conduct. This interpretation is suggested by the relative relaxation of the reliance requirement in both omissions and open market cases. After all, there is less for plaintiffs to do to protect themselves in these situations. Thus, interest in their conduct correspondingly may be allowed to decline. Nonetheless, other mechanisms are available to deal with plaintiff conduct. For instance, due diligence may be made a separate element of the plaintiff's case, even where reliance is presumed. *See, e.g.*, White v. Sanders, 880 F.2d 1366, 1367 (11th Cir. 1982); Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). Thus, the reliance requirement may reflect something more.

²⁸⁶ *See* Basic, Inc. v. Levinson, 485 U.S. 224, 244 (1988); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). In each case, the Supreme Court, without explanation, described causation as requisite to the plaintiff's case. In some circumstances, courts probably have not felt compelled to discuss the need for cause simply because alternative available explanations of the causal connection have had substantial common sense appeal. For instance, where a defendant has made a misrepresentation affecting the public market price at which transactions in a security take place, causation of transaction price does seem to be established, regardless of whether the plaintiff was personally exposed at any time to the misrepresented matter. Where causal linkage exists, it is unnecessary to confront the rationale for requiring it.

²⁸⁷ It even is arguable that the scienter requirement alone, *see supra* note 228 and accompanying text, constitutes such a significant limit on liability that causal contributions to this goal are, at best, redundant. *See infra* note 316 and accompanying text.

based on a fear that defendants will encounter unreasonably large liabilities.²⁸⁸

In contrast to the approaches described above, some courts have indicated a declining interest in causation by allowing recovery for breach of the duty to disclose or refrain from trading even where there is no indication that the plaintiff's market activity was affected in any way by that of the defendant. In these circumstances, however, the need to use customary causal devices to limit liability usually has been obviated by the use of an "unjust enrichment" measure of damages.²⁸⁹ This approach provides a logical cap on liability²⁹⁰ without limiting plaintiffs to compensatory recoveries. It is, however, a small exception to the general trend.

In summary, then, causal requirements under rule 10b-5 apparently have undergone some amount of refashioning and relaxation in recent years. Nonetheless, in cases involving rule 10b-5, the concepts of causation and victim compensation continue to enjoy a primacy absent in the overall context of the express private rights of action.

2. The Express Models and Rule 10b-5

a. *Rejecting the Common Law in Favor of Legislative Precedent*

The rights of action implied on behalf of private plaintiffs under rule 10b-5 logically should not present marked contrasts to the express rights without strong justification. As recognized by courts in the process of implication, the implied rights properly are regarded as an integral part of the scheme established by the private rights that Congress has made express.²⁹¹ An attempt at consistency in this scheme ostensibly has influenced certain aspects of the shape of the implied rights. For instance, the Supreme Court imposed the scienter requirement for private actions under rule 10b-5, in part, because of the stated desire to avoid nullifying the procedural re-

²⁸⁸ See *supra* Part IIA(4) for a discussion of the possible justifications absent such a fear.

²⁸⁹ See *supra* notes 271-73 and accompanying text. Note, however, that unjust enrichment recoveries may have their own causal requisites. See *supra* note 282 and accompanying text.

²⁹⁰ In addition, where the amount disgorged must be shared among a number of plaintiffs, the grossest appearances of windfall are avoided. See *supra* note 69 and accompanying text.

²⁹¹ See *supra* note 103 and accompanying text.

strictions of sections 11 and 12(2) of the '33 Act.²⁹² Now that such a requirement exists, however, the specter of nullification has dwindled, if not vanished. Accordingly, future consistency would seem to depend more on similarities than on differences between implied and express rights.

Ordinarily, incorporation into implied rights of such traditional common law concerns as cause might be justified on the basis that legislative intent is difficult to divine on general matters (i.e., existence of rights), much less specific ones (i.e., the elements of such rights). Common law is a convenient refuge because the legislature presumably was familiar with it and might have "intended" to incorporate it by default.²⁹³ In the context of the misrepresentation rights, however, this explanation falls somewhat flat for several reasons.

First, "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections."²⁹⁴ Thus, Congress acted in reaction to the common law without manifest admiration for its requirements. As a corollary, the Supreme Court itself occasionally has "emphasized 'the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purpose.'"²⁹⁵

Second, where general findings of fundamental legislative purpose are available, these findings can give substantial guidance on fairly narrow issues otherwise relegable to common law analogies.²⁹⁶ Some resolutions of narrow issues almost inescapably will contribute more than others to attainment of given goals. The Supreme Court has held repeatedly that Congress intended both the '33 Act²⁹⁷ and

²⁹² Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-11 (1976); see *supra* note 228 and accompanying text.

²⁹³ See also *infra* notes 340-52 for a discussion of the legislative reenactment theory.

²⁹⁴ Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983); see also SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

²⁹⁵ Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 307 (1985) (eschewing rigid common-law barriers in construing the securities laws); see also A.C. Frost & Co. v. Coeur d'Alene Mines Corp., 312 U.S. 38, 43 (1941); cf. Huddleston, 459 U.S. at 387 n.23 (1983) (old canons of statutory construction subordinated to the doctrine that courts will construe an act's details in conformity with its dominating general purpose).

²⁹⁶ Thus, for instance, the Supreme Court's conclusion that reversionary recoveries under section 12(2) should not be adjusted for tax benefits was guided, in part, by the determination that the '33 Act is intended to do more than insure that defrauded investors will be compensated. It instead was designed to prevent exploitation of the public. Randall v. Loftsgaarden, 478 U.S. 647, 659 (1986) (quoting S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933)).

²⁹⁷ See, e.g., *id.*; cf. Pinter v. Dahl, 486 U.S. 622, 638 n.14 (1987) (policies of securities laws generally include protection of investors as a group, not as individuals).

the '34 Act²⁹⁸ to do *more* than compensate defrauded investors. Thus, it appears inappropriate to adhere uncritically to traditional causal requisites not specifically oriented toward these broader congressional purposes.

In the past, judicial findings of general congressional purposes often have been based on evidence provided by the express private rights.²⁹⁹ In fact, the express private rights also give impeccable evidence of favored means of *attaining* such purposes. Recognition of this fact is simply a variation of the increasingly popular argument that, although statutes customarily are regarded as rules to be applied in specified situations, they also may be useful as persuasive analogies.³⁰⁰ This argument has made headway in a variety of contexts outside the federal securities area.³⁰¹ In addition, there has been scattered judicial recognition that the express private rights for misrepresentation may be used, in at least one regard, as blueprints for rights that courts imply. Thus, a few courts have begun to look to the express private rights in order to establish the appropriate statute of limitations for purposes of rule 10b-5.³⁰²

Lacking, however, at this point in time, is truly consistent reference to express private rights as an indication of either legislative purposes or preferred methods of pursuing them. Indeed, in other (non-cause related) contexts, the Supreme Court sometimes has gone so far as to characterize the existence of express rights as a reason to restrict the use of implied rights. Specifically, the Court has stated that "when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly."³⁰³ This is a form of *argumentum a contrario* or "negative-opposite construction," postulating that legislative enactment of a rule in one situation implies the opposite for other situations.³⁰⁴ This may or may not be

²⁹⁸ See, e.g., *Randall*, 478 U.S. at 664 ("Congress' aim in enacting the 1934 Act was not confined solely to compensating defrauded investors. Congress intended to deter fraud and manipulation in the securities markets, and to ensure full disclosure . . .").

²⁹⁹ See *supra* notes 297-98 for the cited authorities.

³⁰⁰ See Williams, *Statutes as Sources of Law Beyond Their Terms in Common-Law Cases*, 50 GEO. WASH. REV. 554, 558-600 (1982).

³⁰¹ See *id.*

³⁰² See *supra* notes 232-33 and accompanying text. Whether this trend will gain momentum remains to be seen.

³⁰³ *Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979); *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 724 (1975); see also *Pinter v. Dahl*, 486 U.S. 622, 650 (1988) (stating in context of expansive interpretation of liability under section 12(1) of the '33 Act, "[w]hen Congress wished to create such liability, it had little trouble doing so").

³⁰⁴ See A. LENHOFF, COMMENTS, CASES AND OTHER MATERIALS ON LEGISLATION 690 n.2 (1949).

a valid method of deciding which situations are indeed directly controlled by a statute.³⁰⁵ It is clearly a mistake to employ this reasoning to preclude the judiciary from adopting an approach in one context simply because Congress has used it elsewhere. In other words, once a right has been implied, the time for *argumentum a contrario* is past and the shape of the right logically may be patterned after the models Congress has provided expressly.

b. Application of the Models

i. Generally

A judicial attempt to apply rule 10b-5 along the lines of the express models described in Part IIIA(6) above would seem to be completely reasonable and, from a standpoint of consistency, quite desirable. After all, if rule 10b-5 is to be a "catchall" provision,³⁰⁶ is not to "nullify" the express rights,³⁰⁷ and is to be otherwise consistent with the overall scheme of those rights,³⁰⁸ it would be logical to apply the rule to parallel the express models with respect to type of injury presumed and causal showings called for in those fact patterns upon which the models are based. Thus, where there are misrepresentations in the context of private trading, the presumptions of the face-to-face model should be invoked. Where the misrepresentations are addressed to a public market, the approach of the open-market model should be followed.

If courts adopted this suggestion, the rule 10b-5 requirement that the plaintiff prove the defendant's scienter³⁰⁹ should suffice to avoid nullification of any of the express rights for misrepresenta-

³⁰⁵ "The canons requiring strict construction of statutes in derogation of the common law, opposing repeal by implication, holding that *expression unius est exclusion alterius* or *ejusdem generis*, and reading statutes in *pari materia*, have all been used to justify judicial inaction But courts employing those canons were interpreting statutes" Williams, *supra* note 300, at 569-70.

³⁰⁶ See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983) (Section 10(b) is a "catchall antifraud provision"); see also *supra* note 224 and accompanying text.

³⁰⁷ See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976); see also *supra* note 228 and accompanying text.

³⁰⁸ One of the factors set forth by the Supreme Court for consideration in implying private remedies is consistency with the underlying purposes of the legislative scheme. *Cort v. Ash*, 422 U.S. 66, 78 (1975). Subsequent decisions have interpreted and modified these factors to some extent. See, e.g., *Ashford*, *supra* note 102, at 254-90; Pillai, *Negative Implication: The Demise of Private Rights of Action in the Federal Courts*, 47 U. CIN. L. REV. 1, 17-36 (1978); Schneider, *Implying Rights and Remedies Under the Federal Securities Acts*, 62 N.C.L. REV. 853, 877-96 (1984); see also *supra* notes 102-112 and accompanying text.

³⁰⁹ See *supra* note 228 and accompanying text.

tion.³¹⁰ The fact that rights under rule 10b-5 would overlap with the express rights to some extent should be no cause for concern: as the Supreme Court has said, "[i]t is hardly a novel proposition that the Securities Exchange Act and the Securities Act 'prohibit some of the same conduct.'"³¹¹ Moreover, rule 10b-5 would augment the '33 Act's expressly granted rights because of its application both to purchases and to sales. Further, it would augment the '34 Act's express provisions because, in instances where privity is lacking, it nonetheless could be applied to misrepresentations and omissions not contained in a document filed with the SEC.

In addition, rule 10b-5 certainly could continue to serve as a more general catchall for those plaintiffs unable to take advantage of modeled presumptions or believing themselves to have suffered an injury greater than that presumed. Thus, for instance, a plaintiff who entered a subsequently declining public market only because he or she was misled about a particular security still could seek damages in excess of those suggested by the express open-market model. Similarly, a cause of action based on insider trading could exist even without an express analogue.³¹²

ii. Specific Comparisons

Some applications of rule 10b-5 indeed have given rise to results that could have been achieved pursuant to the express models. Nonetheless, courts typically apply the rule without either specific recognition of any parallel express rights or the same overt presumptions. Accordingly, results also have been achieved that bear no resemblance to those suggested by the models.

One glaring divergence of the current application of rule 10b-5 from the modeled approach comes immediately to mind. Rule 10b-5 presently requires the strictest causal showing to be made by plaintiffs suing for affirmative misrepresentations in the context of nonpublic trading. This requirement deviates from the relatively more favorable treatment afforded by sections 12(2) and 29(b) and seems unnecessary given the built-in limitations on defendant lia-

³¹⁰ See *Huddleston*, 459 U.S. at 377 ("[B]ecause the added burden of proving scienter attaches to suits under section 10(b), invocation of the section 10(b) remedy will not 'nullify' the procedural restrictions that apply to the express remedies.").

³¹¹ *Id.* at 376. The Court noted that savings clauses in both the '33 and '34 Acts reject the notion that express remedies would preempt other rights of action. *Id.*; see '33 Act § 16, 15 U.S.C. § 77p (1988); '34 Act § 28(a), 15 U.S.C. § 78bb(a) (1988).

³¹² Such an analogue now does exist. See *infra* Part III(C)(2).

bility afforded by the nonpublic context, even where privity *per se* is lacking.

A second possible divergence from the express models involves the fraud-on-the-market theory recently endorsed by the Supreme Court in the context of trading in public markets.³¹³ This theory drastically relaxes the requirement of the plaintiff's causal showing relative to traditional interpretations of section 18(a).³¹⁴ Such a relaxation does present, however, an inexact parallel to section 11.³¹⁵ Although a strict modeled approach arguably would track the section 18 requirements in instances where section 11's inherent limitations on liability cannot apply—that is, outside the context of a distribution—the complete historical failure of the section 18(a) cause of action suggests otherwise. To the extent there is felt to be some need to impose some additional limit on liability premised on the section 11 causal model, the scienter requirement itself arguably could suffice,³¹⁶ even though scienter is different in kind from other more obvious caps.

A third kind of divergence involves the highly fact-specific demonstration of damages usually required of the plaintiff under rule 10b-5. In contrast, the express models supply presumptions that vastly simplify the plaintiff's task in many circumstances. The courts' application of these presumptions in the rule 10b-5 context, at a minimum, would bring order to a greatly confused area.

As these comparisons further substantiate, in fashioning the causal requisites of rule 10b-5, the courts often have responded to

³¹³ See *supra* notes 244-48 and accompanying text.

³¹⁴ Justice White recognized this point in his dissent to *Basic, Inc. v. Levinson*, 485 U.S. 224, 260-61 (1988).

³¹⁵ The parallel is inexact primarily because the presumption of transaction causation provided for purposes of rule 10b-5 is rebuttable. In contrast, section 11 effectively provides an irrebuttable presumption if the securities in question are purchased prior to the release of the issuer's 12 month earnings statement. See *supra* note 139 and accompanying text.

³¹⁶ The scienter requirement indeed can serve to contribute an additional kind of limit on liability. Cf. *Stock Exchange Practices, Hearings on S. 2693 Before Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 7186 (1934) (statement of George O. May) ("If the section [referring to the predecessor of section 18(a)] is limited to cases of wilful misrepresentation, I do not suppose anyone would be concerned over a possible undue liability in the measure of damages."). This recognition dovetails nicely with the common-law tendency to construe proximate cause expansively where the wrongdoing in question was intentional. See *supra* note 45 and accompanying text.

One should note, however, that combining the section 11 causal model with the scienter requirement does not translate necessarily to the same rough economic correctness ascribed to section 11. See *supra* text accompanying notes 148-49. Any divergence, however, would seem to represent either a shortfall in desired deterrence (which it is too late to correct), or a possible balancing of the need to avoid the chilling of communications outside the context of a '33 Act registration statement.

ancient drumbeats that Congress largely has forsworn. Oddly, in those circumstances in which the drumbeats are disregarded (i.e., in the context of fraud-on-the-market theory), Congress has presented at least one example traditionally regarded as dictating an opposite result. These reversals are puzzling in that current federal doctrine bases the entire implication process upon a finding of legislative intent.³¹⁷ As the following sections of this article illustrate, recent legislative developments have enhanced the curiosity of the situation.

C. *Quasi-Express Rights*

1. The Insider Trading and Securities Fraud Enforcement Act of 1988

The Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFE") became law in November, 1988.³¹⁸ Among other things, ITSFE codified an express private right of action for those who traded in a class of security contemporaneously with "any person who violates any provision of [the '34 Act] or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public information."³¹⁹ The codification of this new right was designated section 20A of the '34 Act.³²⁰

New section 20A provides that the total amount of damages that plaintiffs may collect thereunder is limited to the amount of the profit gained or loss avoided in the transaction that is the subject of the violation.³²¹ This amount is subject to offset by any amounts disgorged in an SEC enforcement proceeding based on the same transaction.³²² The only additional information provided by section 20A³²³ is that it is not intended to affect any other authority of the SEC or the Attorney General,³²⁴ and that it "shall [not] be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title *or the availability of any cause of*

³¹⁷ See *infra* text accompanying note 103.

³¹⁸ 15 U.S.C. § 78a (1988).

³¹⁹ *Id.* § 78t-1

³²⁰ *Id.*

³²¹ *Id.* § 78t-1(b)(1).

³²² *Id.* § 78t-1(b)(2).

³²³ The provision also does contain, however, its own five-year statute of limitations. *Id.* § 78t-1(b)(4). It also has provisions dealing with joint and several liability, *id.* § 78t-1(c), and controlling person liability, *id.* § 78t-1(b)(3).

³²⁴ *Id.* § 78t-1(c).

action implied from a provision of this title."³²⁵ In approving ITSFE, the relevant House Committee clearly felt that it was unnecessary to specifically delineate the activities it intended to address, saying "the Committee . . . declined to include a statutory definition [because] . . . the court-drawn parameters of insider trading [under rule 10b-5] have established clear guidelines . . . and . . . a statutory definition could potentially be narrowing Accordingly, the Committee does not intend to alter the substantive law."³²⁶ The Committee further endorsed the general activity of courts in this area with the following language:

The Committee's intention . . . was to avoid creating an express private cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which have been implied by the courts in this area. Rather, *the Committee wanted to give the courts leeway to develop such private rights of action in an expansive fashion in the future.*³²⁷

Nonetheless, the report reveals that "the codification of a right of action for contemporaneous traders is specifically intended to over-

³²⁵ *Id.* § 78t-1(d) (emphasis added).

³²⁶ H.R. REP. NO. 100-910, 100th Cong., 2d Sess. 11, reprinted in 7 U.S. CODE CONG. & ADMIN. NEWS 6043, 6048 (1988). A more complete quotation is as follows:

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that *the court-drawn parameters of insider trading [under rule 10b-5] have established clear guidelines* for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, *the Committee does not intend to alter the substantive law* with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely known.

Id. (emphasis added).

³²⁷ *Id.* at 27 (emphasis added). Even more broadly, the Committee stated:

Despite the absence of explicit statutory language for private rights of action outside of the contemporaneous trader plaintiff situation, the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders. In the view of the Committee, section 10(b), rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded, or harmed by a violation of any provision of this title or the rules or regulation thereunder by another person's purchasing or selling a security while in the possession of material, non-public information, or communicating such information to others.

Id. at 27-28.

turn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory."³²⁸

Quite simply, then, Congress specifically has acknowledged the existence of implied private rights under rule 10b-5, has approved them, and has encouraged their further development. Congress evidently intended its codification of an express private right for contemporaneous traders primarily to correct the conservative application of the misappropriation theory in private rights of action.

2. The Private Right for Contemporaneous Traders

Section 20A codifies the previously implied right to sue for violations of the duty to disclose or refrain from trading. It contributes, however, some important developments. First, the duty to disclose or refrain arises from the misappropriation of information despite the context of the private action.³²⁹ Second, and very significantly, there is absolutely *no* requirement of injury to the plaintiff, let alone any causal link between the defendant's trading and such injury. Damages are determined strictly by reference to the defendant's gain or loss avoided.³³⁰ Where a plaintiff specifically is injured by the defendant's activity, however, he or she is permitted to sue for additional damages in a congressionally-endorsed action brought under unamended rule 10b-5 or some other relevant provision.

Adoption of section 20A constitutes an effective response of "Who cares?" to the contention that, at least in open market contexts, an insider's trading neither induces anyone else to trade (i.e. causes transactions) nor necessarily has significant impact on the prices at which particular trades occur (i.e. causes transaction prices).³³¹ Thus, the right for contemporaneous traders is a means of policing the laws of insider trading. It is not related to plaintiff compensation,³³² even though some of the private attorneys general

³²⁸ *Id.* at 26 (emphasis added).

³²⁹ See *supra* note 328 and accompanying text.

³³⁰ See *supra* note 321 and accompanying text.

³³¹ See *supra* note 258 and accompanying text.

³³² The primarily deterrent emphasis of section 20A is not at all puzzling, given the recent outcry against the practice of insider trading and the fact that, at least when the penalized insider traded in a public market, no single contemporaneous investor is apt to receive much of a windfall. See generally *supra* note 69. In view of this latter phenomenon, the utility of such a cause of action will depend on the incentive of an attorney to organize

designated actually may have been harmed by the defendants' wrongful acts. Of course, this approach is supported by legislative precedent. In fact, it represents only a moderate variation from the express rights previously discussed.³³³

3. The Systemic Model—Causation Free

New section 20A of the '34 Act accordingly contributes a third model based on congressionally recognized private actions. This model clearly reflects the understanding that certain kinds of activity can impose systemic damages entirely above and beyond those caused to any individual investor. The presumed injury in this case (as reflected by the chosen measure of damages) is that the defendant has gained illicitly,³³⁴ thereby offending social mores and impairing investor confidence.³³⁵ Neither transaction causation nor transaction price causation is of any relevance. This new model, like those that have preceded it, has implications for rule 10b-5.

Before addressing the specifics of rule 10b-5, however, it is useful to summarize the evidence that the new model of section 20A presents as to congressional maneuvering among competing philosophical and analytical approaches. For instance, once again, Congress evidently eschews the ultra-individualist, minimalist state approach to the role of causation referred to in Part IIA(3) above. Section 20A also makes it clear that Congress declines to embrace strict economic analysis as described in Part IIA(5). Although the earlier express models often have supplied damage measures that may be described as more or less "economically correct,"³³⁶ Congress now has chosen to condemn strongly the activity of insider trading.

a class action in many cases. It therefore can be regarded as a "private" cause of action only in a limited sense.

For an analysis of the moral underpinnings of the anti-insider trading outcry, see Note, *Outsider Trading—Morality and the Law of Securities Fraud*, 77 GEO. L.J. 181, 193-209 (1988). The cultural, as well as practical, distaste for insider trading may be illustrated by the former respectability of this practice in Japan and the current pressures for reform in light of western opinion. See, e.g., Sanger, *Insider Trading the Japanese Way*, N.Y. Times, Aug. 10, 1988, at D1, col. 3 (late city final ed.).

³³³ See also *supra* note 97, discussing the private right of action under section 16(b) of the '34 Act.

³³⁴ In this sense, the systemic model is not causation free; it is, however, the defendant's gain, not the plaintiff's injury, that is scrutinized for causal links.

³³⁵ Investor risk aversion logically is minimized by indications that the risk of loss is less than the combined chances of breaking even or gaining. Assuming no general economic decline, this goal can be furthered by preventing any substantial group from procuring a systematized informational advantage.

³³⁶ See *supra* text accompanying notes 149 and 178.

In contrast, the proponents of strict economic analysis typically have concluded that insider trading is either inoffensive or beneficial.³³⁷

Although no single favored congressional philosophy readily appears, in creating express rights, Congress obviously attempts to appeal both to popular morality and common sense. It has erected a structure pursuant to which those who may be publicly perceived as wrongdoers are penalized and those collecting the penalties are the persons most likely to have been injured. The liability imposed occasionally will equal either the amount lost by the injured or the amount gained by the wrongdoer. More importantly, it always will be limited in general accord with common sense. The system in which these ends are achieved may be lacking in philosophical aesthetics, but it certainly is not irrational. Without pretense of precision, the express rights provide that reasonably limited liability may be imposed fairly easily in a multiplicity of cases. The system leaves some gaps, however, through inadvertence or lack of foresight.³³⁸

4. Legislative Reenactment and the Interaction of Section 20A and Rule 10b-5

The adoption of section 20A represents an anomalous situation in which Congress has made the judicial activity involved in the development of an implied right absolutely critical to an express private right of action. This situation has the effect of linking the

³³⁷ In this context, economic arguments have taken specialized forms. Some commentators argue that the ability to trade on inside information provides valuable compensation incentives to managerial employees. See, e.g., Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 869-72 (1983). Others suggest that insider trading may have beneficial informational effects on market prices. *Id.* at 868. In general, however, much of the writing on this subject may be described as fervently anti-regulation.

For a brief sampling of the literature favoring insider trading, see H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 131 (1966); Carlton & Fischel, *supra*; Ross, *The Determination of Financial Structure: The Incentive-Signalling Approach*, 8 BELL. J. ECON. 23, 23-25 (1977); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 549-88 (1970). For counterarguments, see, e.g., Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1438-57 (1967); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1221-48 (1981) (discussing benefits and harms of insider trading without taking a position on prohibition).

³³⁸ The failure of the section 18(a) cause of action inadvertently created one such gap. See *supra* text following note 195. Other gaps have arisen through passage of time. Cf. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (quoting H.R. REP. NO. 98-355, 98th Cong., 2d Sess. at 6 (1983)) ("In recent years, the securities markets have grown dramatically in size and complexity, while Commission enforcement resources have declined.").

history and the future of these rights. In effect, Congress might be said to have "quasi-expressed," rather than expressed, the section 20A cause of action. Moreover, one cannot ignore the ringing endorsement given to future judicial activism in the area of private rights under the '34 Act in general, and rule 10b-5 in particular. The existence of implied private rights under rule 10b-5 now is not only beyond "peradventure,"³³⁹ these rights themselves might be regarded as "quasi-expressed."

Labels aside, the effect on rule 10b-5 of the legislative approach taken in adopting section 20A must be understood in the context of the legislative reenactment theory. The primary thrust of this principle of statutory construction is that when a reenacted statute fails to change the prevailing administrative or judicial interpretation of some earlier version of that statute, the construction in question³⁴⁰ is legislatively endorsed.³⁴¹ Congress is presumed to be generally aware of such interpretations;³⁴² reenactment of a statute after favorable discussion in committee hearings of a relevant interpretation logically conveys particularly strong indicia of approval.³⁴³ Courts regard legislative endorsement as conclusive when repeated reenactments follow notorious interpretations.³⁴⁴

In adopting section 20A, Congress predicated various consequences upon the occurrence of insider trading violations defined by reference to pre-existing provisions of the '34 Act.³⁴⁵ Congress-

³³⁹ See *supra* note 222 and accompanying text.

³⁴⁰ This article draws no distinctions between the processes of interpretation and construction.

³⁴¹ *Herman & MacLean v. Huddleston*, 459 U.S. 375, 385-86 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 378-79 (1982); *Lorillard v. Pons*, 434 U.S. 575, 580-81 (1978); see also 2A C. SANDS, *STATUTES AND STATUTORY CONSTRUCTION* § 49.09 (4th ed. 1973); Agusti, *The Effect of Prior Judicial and Administrative Constructions on Codification of Preexisting Federal Statutes: The Case of the Federal Securities Code*, 15 HARV. J. ON LEGIS. 367 (1978).

³⁴² See generally *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982).

³⁴³ Cf. *United States v. Federal Maritime Comm'n*, 694 F.2d 793, 824 (D.C. Cir. 1982).

³⁴⁴ See, e.g., *Wehrly v. United States*, 808 F.2d 1311, 1315 (9th Cir. 1986); *Ward v. Commissioner of IRS*, 784 F.2d 1424, 1430 (9th Cir. 1986).

³⁴⁵ See *supra* notes 319 and 326 and accompanying text. Congress also had used this approach in legislation adopted in 1984. This earlier legislation was the Insider Trading Sanctions Act of 1984 (ITSA). 15 U.S.C. § 78u(d)(2) (1988). Although it did not address private rights of action, ITSA significantly enhanced the pre-existing penalties for violations of the '34 Act involving the use of nonpublic information. See 15 U.S.C. § 78u(d)(2) (1988). The violations in question were those construed by the judiciary under rule 10b-5. "Again, Congress would not have effectively quadrupled the penalties for insider trading had they been wholly dissatisfied with the underlying approach to the imposition of liability." Langevoort, *Commentary—The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37

sional action thus may be regarded as the theoretical equivalent of reenactment of the pre-existing sections as they relate to insider trading. These provisions already had enjoyed significant administrative and judicial attention. In fact, the original concept of insider trading was the result of judicial interpretation of section 10(b) and rule 10b-5.³⁴⁶

The 1988 legislation thus presented a natural opportunity to address prior judicial developments in the area of insider trading in violation of rule 10b-5. Legislative history indicates both complete cognizance of this opportunity and the stated desire to redirect the courts in only one major regard. Thus, Congress demonstrated its desire for wholehearted application of the misappropriation theory, both in government enforcement contexts *and* in private rights of action.³⁴⁷

More significantly for purposes of this article, however, Congress also endorsed, without fanfare, one of the previously competing approaches³⁴⁸ to the treatment of cause in the insider trading context—selecting, of course, a version that is relatively causation-free.³⁴⁹ If courts do not attend to this endorsement, yet another example of rule 10b-5 divergence from an express model will result. In light of the arguments made in Part IIIB above, such divergence clearly would be inappropriate.

The extent to which rule 10b-5 developments not strictly relating to insider trading have enjoyed reenactment and/or endorsement is not quite so obvious. Legislative action by amendment of one part of a law sometimes has suggested approval of interpretations relating to unchanged provisions.³⁵⁰ More generally, legislative inaction following a well-known course of statutory interpretation has been regarded as some evidence that the legislature has acquiesced in that interpretation.³⁵¹ At the same time, however, leg-

VAND. L. REV. 1273, 1286 (1984). For general discussion of the 1984 legislation, see *id.* at 1286-87; Note, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 469-70 (1985).

³⁴⁶ See *supra* notes 251-61 and accompanying text.

³⁴⁷ See *supra* note 328 and accompanying text.

³⁴⁸ See *supra* notes 260-61 and accompanying text.

³⁴⁹ See *supra* note 330 and accompanying text. *But see supra* note 334.

³⁵⁰ *United States v. Brown*, 333 U.S. 18, 24-25 (1948); *Markham v. Cabell*, 326 U.S. 404, 411 (1945); see also 2A C. SANDS, *supra* note 341, § 49.10.

³⁵¹ For instance, in *Herman & MacLean v. Huddleston*, the Supreme Court held that congressional enactment of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, without amendment of section 10(b), suggested ratification of well-established judicial interpretations of rule 10b-5. 459 U.S. 375, 385-86 (1985). Similarly, in *Basic, Inc. v. Levinson*,

islative inaction has sometimes been called a "poor beacon to follow."³⁵²

Approval of specific judicial developments through legislative reenactment is less conclusive in the non-insider trading context than in the case of the rules relating to insider trading. Thus, for instance, Congress has not endorsed definitively either the courts' continuing fascination with cause as an intrinsic (if sometimes formal) element of the plaintiff's case under rule 10b-5 or the spasmodically relaxing approach to reliance.³⁵³

Nonetheless, Congress has acknowledged and approved specifically the general existence of implied actions under rule 10b-5. Moreover, Congress clearly has indicated that it believes the courts acted properly in deriving a private right against inside traders, and wished only that they had acted more expansively. This indication arguably constitutes approval of the concept of causal relaxation under rule 10b-5. This argument is enhanced by the fact that Congress itself omitted cause as an element of the section 20A action that was intended primarily to expand use of the misappropriation theory and otherwise to incorporate pre-existing law.

5. The Models Revisited

The form of argument involving the use of models has been simple enough thus far: Congress and the courts should be working in alignment but have failed to do so in regard to cause. It seems advisable that the courts look to the causal models provided by the express rights when answering questions raised in the context of rule 10b-5. The picture is greatly complicated, however, by the fact that Congress has become fainthearted in assuming responsibility for the misrepresentation rights. Congress suggests that it would like these rights enlarged, but seems loathe to take the lead for fear

the Court noted that, "[j]udicial interpretation and application, legislative acquiescence and the passage of time have removed any doubt that a private cause of action exists for a violation of section 10(b) and rule 10b-5 and constitutes an essential tool for enforcement of the 1934 Act's requirements." 485 U.S. 224, 229 (1987). *See also, e.g.,* *Canada Packers, Ltd. v. Atchinson, T. & S.F. Ry.*, 385 U.S. 182, 186-87 (1966); *United States v. Shreveport Grain & Elevator Co.*, 287 U.S. 77, 84 (1932); 2A C. SANDS, *supra* note 341, § 49.10.

³⁵² *American Trucking Ass'ns v. Atchinson, T. & S.F. Ry.*, 387 U.S. 397 (1967); *see also* R. DICKERSON, *THE INTERPRETATION AND APPLICATION OF STATUTES* 181 (1975).

³⁵³ This observation is especially true because changing times and markets may present circumstances and possibilities not contemplated by either courts or Congress at earlier dates. *Cf. Huddleston*, 459 U.S. at 388 (typical context in which common-law doctrines of misrepresentation developed was light-years from current securities market).

of inadvertently narrowing what the courts might otherwise succeed in expanding. In contrast, the most recent congressional response to judicial activism in the rule 10b-5 area could be described as both admiring and encouraging.

Thus, rule 10b-5 now may be capable of making a legitimate contribution of its own³⁵⁴ to an understanding of congressional design for the private misrepresentation rights.³⁵⁵ This contribution would be a key in reconciling the models based on the express private rights for misrepresentation and at least some past instances in which courts divergently have applied rule 10b-5. These instances notably would include the use of the fraud-on-the-market theory.³⁵⁶ As already discussed, this theory tends toward the express open-market model provided by section 11, but substantially relaxes the requirement of the plaintiff's causal showing relative to the arguably more relevant model provided by section 18(a). If private actions under rule 10b-5 now possess some measure of congressional endorsement, this development is cause for at least limited celebration, rather than any serious concern.³⁵⁷

Assuming that Congress believes cause to be a means rather than an end, that Congress would like expansion of private misrepresentation rights and that relaxation of causal elements typically will expand, not contract, such private rights, relaxation of causal requirements beyond those provided by any particular express model clearly would be consistent with legislative objectives.³⁵⁸ This change particularly would be true relative to the castrated model provided by section 18(a). In contrast, however, the continued in-

³⁵⁴ Prior acknowledgments of rule 10b-5's independent life have not prominently featured its legitimacy. See, e.g., L. Loss, *supra* note 103, at 726 ("a horse of dubious pedigree but very fleet of foot"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (Rehnquist, C.J.) ("judicial oak which has grown from little more than a legislative acorn"); Painter, *The Use of Rule 10b-5 in Derivative Actions*, in *EMERGING FEDERAL SECURITIES LAWS: POTENTIAL LIABILITY*, 37 (V. Nording ed. 1960) (like a medieval alchemist's "universal solvent," so potent that it dissolves every container employed to hold it).

³⁵⁵ This recognition would, as an initial matter, relieve what would otherwise be a mildly uncomfortable "chicken and egg" problem with the third model itself. After all, judicial development of a cause of action based on inside trading without disclosure predated express recognition of any similar right. In addition, there may be other applications of rule 10b-5 that have limited formal parallel to express private rights. See, e.g., L. Loss, *supra* note 103, at 811-20 for a discussion of the "shingle" theory of broker liability.

³⁵⁶ See *supra* notes 244-48 and accompanying text.

³⁵⁷ The fraud-on-the-market theory still might be criticized for failing to go as far as the model provided by section 11 of the '33 Act. The theory's rebuttability arguably is offset, however, by its lack of a tracing requirement or overall cap on liability.

³⁵⁸ This argument is buttressed by, but does not depend upon, the existence of the scienter requirement. See *supra* text accompanying note 316.

sistence on proof of reliance in nonpublic contexts under rule 10b-5 still cannot be justified; for that matter, neither can the demand for fact-specific damage showings. In light of congressional enthusiasm for rule 10b-5 expansion, the rule's non-scienter requirements should not be interpreted more restrictively than those of the parallel express rights.³⁵⁹

IV. CRITICISM AND CONCLUSION

At present, the express, implied, and quasi-express rights for misrepresentation are complicated and sometimes inconsistent. In fact, the prevailing impression of such rights seems to be that they are an expanding morass of traps for the unwary, giving rise to a need for hypertechnical expertise and incessant litigation.³⁶⁰

One way in which the various rights diverge is with respect to their causal requisites. In cases involving the rights statutorily addressed by Congress,³⁶¹ these variations are understandable as means to ends. This is true even though the causal limitations of section 18(a), in practice, have been too extreme. With respect to implied rights under rule 10b-5, however, the variations are neither consistent within applications of the rule nor understandable in the context of the larger structure of private rights. Thus, for instance, no real predictability exists in the calculation of damages. Moreover, reliance requirements are stricter in nonpublic than in public contexts, a complete reversal of the express scheme.

This article has attempted to demonstrate that the role played by causation in the misrepresentation rights can be rationalized through two fairly simple expedients. First, the federal judiciary should recognize that the express rights for misrepresentation pro-

³⁵⁹ The fact that judicial constructions of rule 10b-5 from time to time have outstripped the parallel express rights without any semblance of congressional objection may suggest an additional use for the rule in shaping the overall scheme for misrepresentation rights. Thus, just as the more express rights may make important logical contributions to the shape of future rule 10b-5 developments, expansive rule 10b-5 constructions might be useful in shaping judicial interpretations of the express rights, at least in those circumstances in which statutory language is not compelling. For instance, this could even encourage relaxation of the courts' especially rigid interpretation of the reliance requirement under section 18(a). Despite the lack of a scienter requirement under that section, such relaxation should not result in undesirable levels of liability; this is true because of the fairly easy "good faith and no knowledge" defense. See *supra* note 188 and accompanying text.

³⁶⁰ Analysts are in virtually unanimous agreement on this point. For an example of the American Law Institute's attempted overhaul of all aspects of the federal securities laws, see FED. SEC. CODE (1980).

³⁶¹ These include the express rights discussed in Part IIIA, *supra*, and new section 20A.

vide both strong indicia of congressional purposes and useful models for attainment of those purposes. Second, this same judiciary should acknowledge the recent directive issued by Congress to expand the usefulness of the implied rights. These factors in combination suggest that the courts could relax implied causal requisites relative to those of the express models, but should not interpret these requisites more restrictively than their express analogues.

Nonetheless, there may be concern that the second rationalizing step accepts and builds upon the method of congressional and judicial interaction referred to earlier in this article as "quasi-expression." This acceptance is based on practical considerations:³⁶² recent indications suggest that all but the most general future developments in the scheme of private rights are primarily in the hands of the courts. In fact, Congress clearly seems to fear impairing the judiciary's ability to deal expansively with private rights and doubts its own ability in this regard. In other words, quasi-expression quite possibly is the method of future law-making that Congress will favor.

This form of law-making is frankly less than ideal. At one time, Congress's freehanded delegation to the courts even might have run afoul of the separation of powers doctrine.³⁶³ Although, at present, this does not seem to be the case,³⁶⁴ "quasi-expression" does appear to have other drawbacks.

³⁶² "[G]uidance for a positive legal scheme must either rub elbows with that scheme or grow chimerical." K. LEWELLYN, *JURISPRUDENCE (REALISM IN THEORY AND PRACTICE)* 114 (1962).

³⁶³ The doctrine of separation of powers dictates that the legislature cannot delegate the legislative function to the judiciary. J. C. SANDS, *supra* note 341, § 4.06. Despite considerable overlap, the legislative function has been distinguished from the adjudicative on several bases. The legislative function is said to involve the creation of "general rules" affecting a "general class," operating prospectively, and creating "primary rights" formerly unavailable. *Id.* § 1.06 at 11; *see, e.g.*, *Prentis v. Atlantic Coast Line Co.*, 211 U.S. 210, 229 (1908). The adjudicative function has been described as involving determinations operating retroactively on limited groups and creating "secondary rights" upon the basis of a pre-existing primary right. C. SANDS, *supra* note 341, § 1.06 at 11. Although courts thus might be said to be legislating in extending common-law rights, objections are most apt to be raised where legislative techniques and the wishes of the people have been ignored. *Id.* at 12; *see* Dittoe, *Statutory Revision by Common Law Courts and the Nature of Legislative Decision Making—A Response to Professor Calabresi*, 28 ST. LOUIS U.L.J. 235 (1984); Peck, *Comments on Judicial Creativity*, 69 IOWA L. REV. 1, 31-45 (1983). *See* Breitel, *The Lawmakers*, 65 COLUM. L. REV. 749, 772-76 (1965), for a discussion of prudent limitations on judicial activism; *see also* *Baker v. Carr*, 369 U.S. 186, 266 (1962) (Frankfurter, J., dissenting); Kurland, *The Supreme Court 1963 Term—Foreword: Equal in Origin and Equal in Title to the Legislative and Executive Branches of the Government*, 78 HARV. L. REV. 143 (1964); Wechsler, *Toward Neutral Principles of Constitutional Law*, 73 HARV. L. REV. 1 (1959).

³⁶⁴ At present, the legislature may permit the courts to determine certain conditions

As an initial matter, quasi-expression arguably calls on courts to do something they are not well suited to do. The traditional judicial role has been adjudication of disputes on the basis of information presented by litigants. Although this process has had inevitable, and extremely useful, precedential effect, it is not designed to deal efficiently with significant policy issues. For instance, there is a risk that all relevant arguments, statistics, etc., will not be mustered in any given case.³⁶⁵ Moreover, a strong possibility exists that inter-party equities in particular cases will skew outcomes from a broader policy perspective.³⁶⁶ Finally, the case-by-case decision-making process simply lacks clarity and moves slowly; it cannot respond quickly to currently pressing problems.

At least some of these criticisms presuppose, however, that the main result desired by Congress is speedy eradication of misrepresentation-related offenses. If, instead, the primary desired result is enhanced public confidence, quasi-expression accompanied by some amount of public fanfare is not a bad solution. Thus, for example,

under which a statute may apply, provided that it outlines legislative policy and fixes controlling principles. See generally *Common Council of Albany v. Town Board of Bethlehem*, 23 A.D.2d 381, 261 N.Y.S.2d 144 (1965). This is in accord with the modern view allowing the exercise by one branch of government of powers of another when it is essential to the discharge of the authority of the exercising branch, is not an assumption of the other branch's whole power, and does not imperil individual liberty. *Quinn v. United States*, 349 U.S. 155, 162-63 (1955); 1 C. SANDS, *supra* note 341, § 3.06, at 53; Pound, *The Place of a Judiciary in a Democratic Polity*, 27 A.B.A. J. 113, 136 (1941); cf. *Perkins v. Lukens Steel Co.*, 310 U.S. 113, 125 (1940); *United States v. Rock Royal Co-op, Inc.*, 307 U.S. 533, 574 (1929). "The commonplace . . . assumes the rightness of courts in making interstitial law, filling gaps in the statutory and decisional rules, and at a snaillike pace giving some forward movement to the developing law." Breitel, *supra* note 363, at 765 (noting failure of judiciary to circumscribe in this manner and calling for restraint).

Thus, separation of powers limits have not prevented courts from extending the scope of a statute to include implied consequences, such as the existence of private rights. 2A C. SANDS, *supra* note 341, §§ 55.02, 55.05. The willingness to engage in implication is justified on the grounds that it is not possible, much less practical, for the legislature to specify all the effects of a statute in all circumstances. *Id.* Moreover, the danger of judicial activism through implication seems limited. To the extent the implication process is premised on legislative intent, it is a fairly simple matter for the legislature to redress unwanted results. This rationale clearly is related in spirit to the legislative reenactment theory. See generally Creswell, *The Separation of Powers Implications of Implied Rights of Action*, 34 MERCER L. REV. 973 (1983).

³⁶⁵ For discussion of this type of limitation on judicial decision-making ability in the context of the political question doctrine, see Scharpf, *Judicial Review and the Political Question: A Functional Analysis*, 75 YALE L.J. 517, 566-96 (1966); see also A. BICKEL, *THE LEAST DANGEROUS BRANCH* ch.4 (1962) (discussing various mechanisms of judicial restraint).

³⁶⁶ For an attempt to address this phenomenon, see the Supreme Court's approach to *in pari delicto* defenses in federal securities contexts. Cf. *Pinter v. Dahl*, 486 U.S. 622, 654-55 (1988); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 318-19 (1985).

if identifiable individuals are *not* actually suffering harm caused by inside traders,³⁶⁷ the only step immediately required to respond to the systemic injury of lack of confidence is a statement that someone is addressing the problem of insider trading. Thereafter, inside traders must eventually be caught and punished to preserve the desired effect, but the urgency of this phase may not be pressing.

In addition, the arguments premised on judicial ineptness assume the virtues of certainty to be self-evident. In fact, temporary lack of clear-cut rules itself may have certain virtues. Obscurity avoids an inadvertent narrowing of proscribed activities and has a deterrent effect all of its own.³⁶⁸ Thus, persons contemplating actions that might or might not give rise to legal consequences simply may abstain from the questionable behavior, saving both enforcement effort and judicial resources. Thus, obscurity may have net benefits if the value of the deterred, albeit arguably lawful, behavior is low.

The most important response, however, to criticisms based on the deficiencies of courts in addressing general policy matters is the observation that, in the field of securities regulation, general policy is one of the few things as to which Congress has been relatively clear. Congressional delegation of the execution of this policy to the courts may result in a few legal goatpaths, but conscientious judicial reading of congressional signposts should keep those paths meandering in the right direction.

Perhaps the larger problems presented by Congress's recent use of quasi-expression arise not because it has specified broad goals and then delegated the detail work to the courts, but because Congress has concealed somewhat the act of delegation itself. This concealment results from the use of legislative history, rather than statutory language, to deliver directives to the judiciary.

Legislative history is a valuable interpretive tool but, as a matter of course, it should not be favored over statutory language for matters of real significance. For one thing, the legislative history approach arguably fails to give meaningful notice either to generally

³⁶⁷ See *supra* note 260 and accompanying text.

³⁶⁸ See *Baggett v. Bullitt*, 377 U.S. 360, 372 (1964) ("Those . . . sensitive to the perils posed by . . . indefinite language avoid the risk . . . only by restricting their conduct to that which is unquestionably safe."); see also G. GUNTHER, *CONSTITUTIONAL LAW* 1156 (11th ed. 1985) (alluding to chilling effect of vague regulations); Amsterdam, *The Void-for-Vagueness Doctrine in the Supreme Court*, 109 U. PA. L. REV. 67, 89-96 (1960) (general discussion of vagueness doctrine). Note, however, that this article is not attempting to create or respond to any assertion of unconstitutional vagueness.

interested congressional constituencies or to individuals whose legal postures may be affected directly by law-making in the relevant area.³⁶⁹ For another, courts easily may miss or ignore legislative history, particularly where the history in question is associated specifically with one rather specialized provision but purports to address the interpretation of other sections.³⁷⁰ Such a situation is presented by the use of the legislative history relating to new section 20A to endorse interpretations of section 10(b) and rule 10b-5.

In fact, Congress should be able to develop and articulate more overt expressions of goals without restricting judicial latitude to achieve them. For instance, legislative history suggests that private causes of action for insider trading are supposed to supplement SEC enforcement activities. In this instance, section 20A itself might have announced directly that such actions serve a deterrent, rather than a compensatory, function, and that all questions not addressed specifically by the statute should be resolved accordingly. This type of expression in other contexts, especially that of section 10(b), also would be useful.³⁷¹ If such policy statements were more regular landmarks of the securities landscape, it is possible that major inconsistencies in causal and other requirements could be entirely avoided.³⁷²

³⁶⁹ "The maxim that people are held to know the law becomes unfair concerning portions of the law which are essentially undiscoverable. Basing decisions of statutory interpretation on historical events that are, practically speaking, obscured from the awareness of persons not directly involved in the legislative process has the character of enforcing secret laws." 2A C. SANDS, *supra* note 341, § 48.02, at 284.

³⁷⁰ Glowing words about the misappropriation theory contained in the history of the Insider Trading Sanctions Act of 1984 apparently had little effect on the Supreme Court's consideration of the subject in 1987 in the case of *Carpenter v. United States*, 484 U.S. 19, 24 (1987); *see also supra* note 258. *Carpenter* was working its way through the lower courts at the time the 1984 legislation was enacted. It was cited in the legislative history as a prime example of the type of abuse that Congress wished to penalize. *See* 130 Cong. Rec. H7757 (daily ed. July 25, 1984) (statement of Rep. Dingell); The Insider Trading Sanctions Act of 1983, *Senate Hearings on HR 559 Before the Subcommittee on Securities*, 98th Cong., 2d Sess. 2, 37 (1984). The Supreme Court, however, seems to have been unimpressed and has evenly split on the validity of the misappropriation theory, even in the context of SEC enforcement.

³⁷¹ For instance, the preamble to section 16(b) of the '34 Act, 15 U.S.C. § 78p(b) (1988), has been a valuable contribution to that provision's jurisprudence. *See, e.g., Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). Nonetheless, section 16(b)'s preamble has not dispelled all confusion about the circumstances in which the statute is to be applied. *See generally* Block & Barton, *Section 16(b) of the Exchange Act: An Archaic Insider Trading Statute in Need of Reform*, 12 SEC. REG. L.J. 203 (1984); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses*, 1981 DUKE L.J. 941 (1981); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 NW. U.L. REV. 221 (1975).

³⁷² Not all statements of purpose, however, will be helpful. For example, the introduction to the '34 Act itself is more general than might be desired. 15 U.S.C. § 78b (1988).

Nonetheless, the most immediately practical observation as to improvement either in the role of cause in the private misrepresentation rights, or in general federal securities law-making, must be directed to the federal courts. This observation may be summarized as follows: in this day and age, it is disingenuous for a court to take the position that "[w]hen Congress wished to create such liability, it had little trouble doing so."³⁷³ In fact, Congress recently has experienced great difficulty in stating exactly what it wishes in the securities field. At least for the present, if congressional intent is to be of any meaning in this area, judicial sensitivity to even the most subtle congressional signal must be acute.

³⁷³ *Pinter v. Dahl*, 486 U.S. 622, 650 (1988); *see also Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979) ("[W]hen Congress wished to provide a private damage remedy, it knew how to do so and did so expressly."); *supra* note 303 and accompanying text.