Panzirer v. Wolf: An Extension of the Fraud-on-the-Market Theory of Liability under Sec Rule 10b-5

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The Securities and Exchange Commission's rule 10b-5,1 promulgated pursuant to section 10(b)2 of the Securities Exchange Act of 1934, prohibits fraud in connection with the purchase or sale of securities.3 The rule's broad antifraud provisions are designed to protect investors by promoting full disclosure of information in lieu of the preexisting doctrine of caveat emptor.4 The rule thus embraces the philosophy inherent in the securities

1. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1982) provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
3. See supra notes 1-2.
   Implementation of full disclosure is, however, one among many policies underlying rule 10b-5. See SEC Exchange Act Release No. 3230 (May 21, 1942) (protecting investors); see also Herman & MacLean v. Huddleston, 103 S. Ct. 683, 691 (1983) (achieving high standards of business ethics in the industry); Fridrich v. Bradford, 542 F.2d 307, 324 n.6 (6th Cir. 1976), cert. denied (deterring fraud and compensating investors), 429 U.S. 1053 (1977);
   Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied (maintaining free and honest markets), 429 U.S. 816 (1976); Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974) (encouraging investor confidence in the securities market). For a full discussion of policies
laws that full and accurate disclosure of information will promote knowledgeable investment decisions and will ensure that the price of securities accurately reflects their intrinsic value.  

While the Securities and Exchange Commission (SEC or Commission) has authority to enforce the rule, neither section 10(b) nor rule 10b-5 expressly provides a private right of action for defrauded investors. Although there is very little documented evidence of Congress's intent in enacting section 10(b) or of the SEC's purpose in promulgating rule 10b-5, fostered by the rule, see 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 §§ 6.00-6.09 (2d ed. 1981).

5. One theory underlying the securities laws' mandatory disclosure requirements is the "efficient market hypothesis," whereby information about a company is instantly reflected in the price of that company's stock. For a full discussion of the efficient market hypothesis, see Note, Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend, 29 STAN. L. REV. 1077 (1977); R. JENNINGS & H. MARSH, SECURITIES REGULATION, 163-67 (5th ed. 1982); see also In re LTV Sec. Litig., 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). For a discussion of the efficient market hypothesis in rule 10b-5 actions where fraud has affected the market, see Note, The Fraud-on-the-Market Theory, 95 HARV. L. REV. 1143 (1982).


The SEC does not, however, have enough personnel and time to pursue all meritorious claims. In view of the SEC's limited arsenal for punishing those who violate the securities laws, the implied private right of action under rule 10b-5 is seen as an important supplement to Commission enforcement. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (citing J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (implied private right of action for proxy violation)); see also 5 A. JACOBS, supra note 4, at § 8.01, 1-109 ("[t]he main source of enforcement is private attorneys general bringing suit 'as a necessary supplement to Commission action'.") For more complete discussion of the SEC's role in enforcing rule 10b-5, see 5 A. JACOBS, supra note 4, at § 15.


8. What is now § 10(b) was originally drafted as § 9(c) of the Exchange Act. H.R. 7852 & S. 2693, 73d Cong., 2d Sess. (1934); H.R. 8720 & S. 3420, 73d Cong., 2d Sess. (1934) (second version of proposed § 9(c)). Thomas G. Corcoran, the Administration's spokesman, stated that "[s]ubsection (c) [now § 10(b)] says, 'Thou shalt not devise any other cunning devices.'" HEARINGS ON STOCK EXCHANGE REGULATION BEFORE THE HOUSE COMM. ON INTERSTATE COMMERCE, 73d Cong., 2d Sess. 21 (1934).

The House report commenting on § 10(b) states only that it is designed to prohibit such fraud as may be "necessary or appropriate in the public interest or for the protection of
5, courts implied a private right of action under the rule as early as 1947. Today, the existence of this implied private right of recovery is not

investors." H.R. Rep. No. 1838, 73d Cong., 2d Sess. 32-33 (1934). Similarly, the Senate Committee Report, making reference to the purpose of § 10(b) in protecting the "interests of investors," is of little help to courts interpreting § 10(b) and rule 10b-5. See, e.g., S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934). For a comprehensive legislative history of the securities laws, see Duncan, Selected Bibliography Including Legislative History of the Securities and Exchange Commission and the Statutes it Administers, 28 Geo. Wash. L. Rev. 938 (1959); see also 5 A. Jacobs, supra note 4, at § 5.01. For cases discussing the lack of evidence of Congress's intent in enacting § 10(b), see Santa Fe Indus., 430 U.S. at 473 n.13; Hochfelder, 425 U.S. at 196, 196 n.14.

9. Rule 10b-5 was designed to close a loophole in the coverage of the securities laws' antifraud provisions. While §§ 11, 12(1), 12(2) & 17(a) of the Securities Act expressly prohibit fraudulent sales of securities, they only cover fraud in connection with the sale of securities. Securities Exchange Act § 15 prohibits fraud in connection with the purchase of securities, but covers brokerage transactions in the over-the-counter markets. 15 U.S.C. § 78o (1976). The promulgating release for rule 10b-5 states that it "closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Exchange Act Release No. 3230 (May 21, 1942); see 8 SEC Ann. Rep. 10 (1942) (rule 10b-5 "prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers"); accord SEC Exchange Act Release No. 3634, 1 (Dec. 22, 1944). For an interesting account of the facts leading up to the promulgation of rule 10b-5, see the remarks of Milton V. Freeman in Conference on the Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967). For a thorough discussion of the administrative history of the rule, see 5 A. Jacobs, supra note 4, at § 5.02; Duncan, supra note 8; see also Huddleston, 51 U.S.L.W., at 4104 (discussing the lack of evidence of SEC intent in promulgating rule 10b-5); Hochfelder, 425 U.S. at 196, 196 n.15 (citing SEC Exchange Act Release No. 3230 (May 21, 1942)).


The elements of a rule 10b-5 private right of action are:

(1) a misstatement of material facts or a failure to disclose material facts. A fact is "material" if a reasonable investor would consider it important when making an investment decision. TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 445-46 (1976), discussed infra note 16;

(2) the fraud "in connection with" a "purchase or sale of any security." See supra notes 1-2. In Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971), the Supreme Court broadly interpreted the "in connection with" language of the rule and statute to mean that the proscribed act "touches" upon the particular purchase or sale. In Blue Chip Stamps, however, the Court restrictively construed "purchase or sale" by requiring an actual, as opposed to potential, purchase or sale. 421 U.S. at 747, discussed infra note 12;

(3) an intention to deceive, manipulate or defraud. Hochfelder, 425 U.S. at 193;

(4) reliance on the misstatement or omission. Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981), cert. denied, 102 S. Ct. 1427 (1982); Huddleston v. Herman & MacLean, 640 F.2d 534, 548 (5th Cir. 1981), aff'd in part and rev'd in part, 103 S. Ct. 683 (1983). But see infra note 17 (reliance is not necessary when the alleged fraud is nondisclosure and may...
only unquestioned,\textsuperscript{11} but also has become, by judicial interpretation and construction, the most widely invoked provision of the securities laws in civil suits for damages.\textsuperscript{12} The implied private right of action created under}

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\item be presumed in actions involving omissions, misrepresentations, or fraud affecting the market; and
\item (5) a causal connection between the violation of the rule and the injury. Affiliated Ute Citizens, 406 U.S. at 153-54. See infra notes 18 & 72.
\end{itemize}

\textsuperscript{11} In 1971, the Supreme Court explicitly recognized a private right of action for violations of § 10(b) and rule 10b-5. Superintendent of Ins., 404 U.S. at 13 n.9; see Huddleston, 103 S. Ct. at 687 ("[T]he existence of this implied remedy is simply beyond peradventure"); Hochfelder, 425 U.S. at 196 and cases cited therein; see also Cort v. Ash, 422 U.S. 66 (1975) (four factors to consider in determining whether a private right of action should be implied); cf. Merrill Lynch, Pierce, Fenner and Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982) (private right of action implied under the Commodities Exchange Act); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (no implied private right of action under § 206 of the Investment Advisers Act); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (no private right of action under § 17(a) of the Securities Exchange Act).

To imply a private right of action, early cases looked to the common law tort principle that a private right of action is predicated on the grounds that a person injured by a violation of a statute enacted for his benefit is entitled to sue and recover damages. Kardon, 69 F. Supp. at 513-14. For both early and recent cases citing this formulation, see 5 A. JACOBS, supra note 4, at § 8.02 n.1. A second plausible basis for the private right of action has been found in § 29(b) of the Exchange Act, which declares void any contract in violation of the Act or its rules. See Blue Chip Stamps, 421 U.S. at 735. For a complete discussion of cases applying this theory, see 5 A. JACOBS, supra note 4, at § 8.02[b], § 8.02[b] n.4. A third basis of a rule 10b-5 implied right of action is the statutory implication theory. See Borak, 377 U.S. at 431-32; 5 A. JACOBS, supra note 4, at § 8.02[c], 1-207 ("the essence of the [statutory implication theory] is that the underlying bases of the Exchange Act plus a general grant of jurisdiction to the courts are sufficient to create an implied private right of action"). The Supreme Court has favored an approach that emphasizes congressional intent. See Touche Ross, 442 U.S. at 578. In view of the scant legislative and administrative history of § 10(b) and rule 10b-5, the Court, in determining congressional intent, has held that congressional acquiescence in the cumulative nature of § 10(b) and rule 10b-5 thereunder amounts to ratification of the implied private right of action. See Huddleston, 103 S. Ct. at 689.

In recent cases, however, the Court has emphasized congressional intent when deciding whether to imply a private right of action. See Huddleston, 103 S. Ct. at 689; Touche Ross, 442 U.S. at 578. In Huddleston, the Court held that the availability of an express remedy under § 11 of the Securities Act, 15 U.S.C. § 77k (1976), does not preclude an action under § 10(b) and rule 10b-5. 103 S. Ct. at 690. In support of its holding, the Court took cognizance of the fact that when Congress substantially revised the securities laws in 1975, most federal courts permitted suit under § 10(b) and rule 10b-5 regardless of the availability of other express remedies and concluded that "Congress' decision to leave Section 10(b) intact suggests that Congress ratified the cumulative nature of the Section 10(b) action." Id. at 4102 (citing Curran, 102 S. Ct. 1825 (1982) and Lorillard v. Pons, 434 U.S. 575, 580-81 (1978)).

\textsuperscript{12} Ross v. A. H. Robbins Co., 607 F.2d 545, 556 (2nd Cir. 1979), cert. denied, 446 U.S. 946 (1980). In Blue Chip Stamps, the Court noted that flexible judicial interpretation of the rule 10b-5 private right of action has caused the rule to become "a judicial acorn, which has grown from little more than a legislative acorn." 421 U.S. at 737. However, the Court "express[ed] concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good," id. at 747-48, and held
rule 10b-5 operates to compensate the victims of securities fraud and to enhance the rule’s prophylactic effect by subjecting those who engage in proscribed behavior to civil liability.13

In delineating the elements of a cause of action under the rule for private investors,14 courts have borrowed aspects of the closely analogous common law action for deceit.15 Materiality,16 reliance,17 and causation18 are three elements of a rule 10b-5 cause of action that have a common law

that only actual purchasers or sellers of securities have rule 10b-5 standing. Id. at 747. In doing so, the Court explicitly precluded recovery by those who would have purchased or sold as a result of actions in violation of the rule. Id. at 734-35. The Court justified its restrictive reading by stating that, when construing rule 10b-5, "[t]hey] are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless or until Congress addresses the question." Id. at 748-49. *Blue Chip Stamps* was the first in a series of Supreme Court decisions limiting the scope of rule 10b-5. *See* Chiarella v. United States, 445 U.S. 222, 232-33 (1980) (duty to disclose nonpublic information when trading in securities does not arise simply by virtue of the act of trading securities while in possession of nonpublic information but may arise from an agency or fiduciary relationship with the issuer of securities in criminal actions pursuant to rule 10b-5); *Santa Fe Indus.,* 430 U.S. at 472-80 (mere breach of fiduciary duty is not "deceptive" or "manipulative" within the meaning of § 10(b) or rule 10b-5 when there is an appropriate remedy in state law); *Hochfelder,* 425 U.S. at 193, 212-15 (scienter required in rule 10b-5 actions; no action for mere negligence); *cf. Touche Ross,* 442 U.S. 560 (no private right of action under § 17(a) of Exchange Act); *Piper v. Chris-Craft Indus.,* 430 U.S. 1 (1977) (no private right of action under § 14(e) of the Exchange Act for unsuccessful tender offerer).

Two recent decisions may, however, signal an end to the Court’s restrictive reading of rule 10b-5 and other provisions of the securities laws. *See* Huddleston, 103 S. Ct. at 690 (availability of express remedy under § 11 of the Securities Act does not preclude a private action under rule 10b-5); *Curran,* 102 S. Ct. at 1825 (implied private right of action for violation of the Commodities Exchange Act).

13. One reason advanced for the existence of the rule 10b-5 private right of action is so that private plaintiffs may supplement the Commission’s authority to enforce the rule. *See supra* note 11 and accompanying text.

14. For the elements of a rule 10b-5 cause of action, *see supra* note 10.

15. The hornbook elements of an action for fraud are: (1) false misrepresentation by the defendant; (2) knowledge or belief on the part of the defendant that the representation is false, or the defendant’s lack of a sufficient basis of information to make the representation; (3) an intention by the defendant to induce the plaintiff to act or refrain from acting in reliance on the misrepresentation; (4) justifiable reliance by the plaintiff in acting or refraining from acting; and (5) damage due to such reliance. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971). Reliance was necessary to provide the causal link. *Id.* § 108, at 714.

The elements of a cause of action under rule 10b-5 are not identical to the elements of a common law fraud action. In fact, rule 10b-5 has been the basis of liability in several situations where common law fraud theory would otherwise have been insufficient. *See Huddleston,* 103 S. Ct. at 691; *infra* notes 23-31 and accompanying text.

16. Clause (b) of the rule makes it unlawful to misstate material facts or to fail to disclose material facts that render a statement misleading. *See supra* note 1. Although clauses (a) and (c) do not specifically mention the term “material,” the materiality requirement has...
basis. At common law and in early rule 10b-5 actions, proof of these three conceptually distinct but interrelated elements was a prerequisite to recovery. Traditionally, this meant that a plaintiff had to prove (1) direct reliance; (2) that the defendant's action was the proximate cause of the investor's loss; and (3) that the fraud involved material misrepresentations or omissions. See Affiliated Ute Citizens, 406 U.S. at 153-54.

In TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976), a case brought for violation of § 14(a) of the 1934 Act, the Court held that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. at 449 (emphasis added). The TSC opinion suggests that this formulation of materiality governs rule 10b-5 actions. Id. at 445-46 n.3, 447 n.9. It has been so interpreted by several courts. SEC v. Mize, 615 F.2d 1046, 1051 (5th Cir. 1980); Zweig v. Hearst Corp., 594 F.2d 1261, 1266 (9th Cir. 1979); SEC v. Research Automation Corp., 585 F.2d 31, 35 n.8 (2d Cir. 1978). See also 5A A. Jacobs, supra note 4, at § 61.02[b][ii], 3-115 n.40. See generally 5A A. Jacobs, supra note 4, at § 62.

17. In a common law action for deceit, proof of direct reliance was a prerequisite to recovery. Establishing reliance involves a dual inquiry: (1) did plaintiff believe defendant?; and (2) did plaintiff act upon that belief by purchasing or selling securities? See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 n.6 (2d Cir. 1981); R. Jennings & H. Marsh, supra note 5, at 1047.

Under rule 10b-5, however, direct reliance on misrepresentations is only required when a complaint alleges an affirmative misrepresentation of fact in a face-to-face transaction. See infra notes 73-78 and accompanying text. In actions involving complete nondisclosure where there is a duty to disclose facts, reliance is no longer necessary. See Affiliated Ute Citizens, 406 U.S. at 153-54. See also infra notes 65-92 and accompanying text. In cases where the alleged fraud is a misrepresentation or omission of material fact, reliance may be presumed. See infra notes 93-113 and accompanying text. When there is fraud in violation of any of the provisions of rule 10b-5, and that fraud affects the autonomy of the market in generating accurate information about the intrinsic value of securities, then indirect reliance on the fraud is sufficient for the purposes of establishing a rule 10b-5 claim if the allegedly defrauded investor relies on the integrity of the market in disseminating information when making a losing purchase or sale of securities. See infra notes 114-84 and accompanying text.

In determining the degree of reliance required, the Second Circuit has applied a “substantial factor” test, holding that the fraud does not need to be the sole cause of the purchase or sale, but only a “significant contributing cause.” Panzirer v. Wolf, 663 F.2d 365, 367 (2d Cir. 1981), cert. granted, 102 S. Ct. 3481 (1982), vacated and remanded with instruction to dismiss with prejudice, 103 S. Ct. 683 (1983); Wilson, 648 F.2d at 92; Herzfeld v. Laventhal, Kreckstein, Horwath & Horwath, 540 F.2d 27, 33-34 (2d Cir. 1976).

Professor Jacobs refers to three types of reliance that may be required in a rule 10b-5 action: “constructive reliance,” “actual reliance,” and “reasonable reliance.” “Constructive reliance” refers to reliance that has been presumed. “Actual reliance” is reliance that is either direct or indirect. Reliance on misrepresentations or omissions is “reasonable” when the fraud is material. See 5A A. Jacobs, supra note 4, at § 64.02[b][ii]-[iii].

18. In Affiliated Ute Citizens, the Court found that the causal relationship that must exist is that of causation in fact. 406 U.S. at 154. See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) (proxy rules case); see infra note 72 for a discussion of causation. Affiliated Ute Citizens did not, however, decide how close that relationship must be. Some courts have applied the principles of proximate cause and foreseeable injury. See, e.g., Hudleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1974), aff'd, 103 S. Ct. 683 (1983); see generally, 5A A. Jacobs, supra note 4, at § 64.02.

19. The courts measure materiality by objective standards, and in each case determine...
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While courts continue to require proof of materiality and causation, direct reliance on misrepresentations is currently considered inappropriate in the context of most actions brought pursuant to the rule. As a result of this departure from the common law reliance requirement, the neat distinctions traditionally maintained between the concepts of reliance, materiality and causation have broken down.

The departure from common law notions of reliance in rule 10b-5 actions may be attributed to fundamental differences between the prophylactic purpose behind the rule and the limited nature of protection provided by an action for common law fraud. An action for common law deceit is available only when there has been an affirmative misstatement of fact in a face-to-face transaction. Rule 10b-5, on the other hand, provides far

whether a reasonable person would act on the basis of a particular misrepresentation or omission. See TSC, 426 U.S. at 449; see also supra note 16. Reliance, on the other hand, involves a subjective inquiry, where the issue is whether the particular investor believed and acted upon the misrepresentations. See Wilson, 648 F.2d at 92 n.6; R. JENNINGS & H. MARSH, supra note 5, at 1047. Although reliance is considered part of causation, see Huddleston, 640 F.2d at 547; 5A A. JACOBS, supra note 4, at § 64.01(b)(ii) n.6 and cases cited therein, the two concepts involve different analyses. Causation focuses on the connection between the defendant's fraud and the plaintiff's loss, see Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), appeal pending, 102 S. Ct. 1424 (1982); Vervaekte v. Chiles, Heidler & Co., 578 F.2d 713, 715 (8th Cir. 1978); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975), whereas reliance concerns the relationship between the fraud and the purchase or sale, see, e.g., Schlick, 507 F.2d at 380-81. See also 5A A. JACOBS, supra note 4, at § 64.02.

20. See supra note 15.


Reliance is no longer necessary in actions involving complete nondisclosure brought pursuant to rule 10b-5(a) or (c). Affiliated Ute Citizens, 406 U.S. at 153-54. See also infra notes 65-92 and accompanying text. Reliance may be presumed in cases involving misstatement or omission of material facts in violation of rule 10b-5(b). See, e.g., Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), cert. denied, 51 U.S.L.W. 3508 (U.S. Jan. 10, 1983); see also infra notes 93-113 and accompanying text. When fraud, be it a misstatement, omission or nondisclosure of material information, affects the accuracy of information generated in the securities market, reliance on the integrity of the market in producing information may be an essential element of a rule 10b-5 cause of action. Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). See infra note 19.

22. See 5A A. JACOBS, supra note 4, at § 66.01(a) n.8; see supra notes 16-19 and accompanying text. See also, Stoll, Reliance as an Element in 10b-5 Actions, 53 Or. L. Rev. 169 (1974).

23. See Huddleston, 103 S. Ct. at 691 (citing Blue Chip Stamps, 421 U.S. at 744-45 (“the typical fact situation in which the classic tort of . . . deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable”). 5 A. JACOBS, supra note 4, §§ 2.00-2.05; 3 L. Loss, SECURITIES REGULATION 1435 (2d ed. 1961).

24. See 5 A. JACOBS, supra note 4, at § 2, 1-6 (“[pre 1942 common law sometimes permitted recovery by a plaintiff who bought or sold stock on the basis of a misrepresenta-
more protection against fraudulent practices than the common law action of deceit. Clause (b) of the rule proscribes the use of both untrue statements of material fact and material omissions of information that render an otherwise accurate statement misleading. Furthermore, clauses (a) and (c), prohibiting participation in fraudulent schemes or courses of conduct, bring circumstances involving complete nondisclosure within the purview of the rule. In a rule 10b-5 action where the alleged fraud consists of fraudulent omissions or nondisclosures, actual reliance is difficult, if not impossible, to prove.

The broad antifraud provisions of rule 10b-5 compensate for the common law deficiencies by expanding the scope of unlawful behavior, thereby raising the standards of conduct in the industry. The rule thus provides an incentive to comply with the disclosure mandates of the securities laws. If corporate issuers of securities fully disclose accurate information, the price of the stock should reflect this information. Hence, the price of a given security should be an indication of its intrinsic value. If, however, fraudulent information or perceptions about an issuer of securities enters the market, then the price of that issuer's security may become artificially inflated or deflated and no longer represent the intrinsic value of the

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2. See Affiliated Ute Citizens, 406 U.S. at 151; see also supra note 4.

23. See Note, supra note 4, at 1089-90: "The efficient capital market hypothesis asserts that all available, relevant information about a company's financial prospects is fully and virtually instantaneously reflected in the market price of the company's securities."
underlying security. Thus when fraud has manipulated the price of stock, a purchaser or seller who relies on the price of stock as an indication of its value may incur a loss, even if that investor has not directly relied on any misrepresentations.

Responding to the unique nature of securities fraud and the prophylactic purpose of rule 10b-5, courts have either modified or eliminated the reliance requirement when the factual context of the action renders proof of reliance an onerous evidentiary burden. Case law indicates that traditional common law reliance is required only when the complaint alleges a misstatement of fact in a face-to-face transaction, bringing the action within the parameters of a common law action for deceit. Because reliance is considered part of causation, the recent alterations in the reliance requirement have made it difficult for courts to determine how causation may be established when there is no proof of actual reliance and whether an affirmative showing of nonreliance defeats an action brought pursuant to the rule.

In cases involving complete nondisclosure implicating clauses (a) or (c) of the rule, and in cases of deceptive omissions within the purview of clause (b), courts have used an “objective approach” to liability whereby the materiality of nondisclosure or omission may establish causation. This specific inquiry under this objective approach depends, however, upon whether the alleged fraud is a nondisclosure or omission. In complete nondisclosure cases, causation may be established when there is a duty to disclose and a withholding of material facts. In deceptive omission cases, reliance may be presumed upon a showing of a failure to reveal material facts. Once reliance is presumed, causation is circumstantially es-

30. See Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976) (the price of stock may also reflect misrepresentations); In re LTV Sec. Litig., 88 F.R.D. 134, 144 (N.D. Tex. 1980) (the market price of stock will reflect all available information, including misrepresentations).
31. See Blackie, 524 F.2d at 907.
32. See supra note 21.
33. Common law deceit is available only when there is an affirmative misrepresentation of fact in a face-to-face transaction. See supra note 24 and accompanying text.
34. Huddleston v. Herman & MacLean, 640 F.2d 534, 547 (5th Cir. 1979), aff'd, 103 S. Ct. 683 (1983). See also supra notes 15 and 19.
35. The approach is objective in that the materiality of concealed facts, tested by a standard of reasonableness, establishes causation. See Affiliated Ute Citizens, 406 U.S. at 153-54; Mills, 396 U.S. at 385. See also infra note 72 and accompanying text.
36. See Affiliated Ute Citizens, 406 U.S. at 153-54 (in cases involving primarily a failure to disclose material facts coupled with a duty to disclose, causation in fact has been established). See also Mills, 396 U.S. at 385 (material omission in proxy statement). See infra note 72 and accompanying text.
tablished. In most cases, the defendant may rebut the inference of causation by proving nonreliance. Thus, recovery under this objective approach may depend upon a characterization of the fraud as a material nondisclosure or omission.

A second approach to reliance and causation has developed in the lower federal courts whereby an investor may recover for losses incurred in transactions where fraud has affected the price of the particular security. This so-called “fraud-on-the-market” theory of liability differs from the objective approach in that reliance is a prerequisite to recovery. In contrast with the common law, however, proof of direct reliance on misstatements is not necessary. Instead, a plaintiff need only allege reliance on the “integrity of the market” in producing accurate price data. In order to recover damages using a fraud-on-the-market theory, the characterization of the fraud as an omission or as a nondisclosure is irrelevant. Rather, there must be a showing of fraud that has affected the price of a particular stock, a purchase or sale in reliance on the integrity of the market price, and a loss resulting from the purchase or sale.

In Panzirer v. Wolf, the Second Circuit extended the fraud-on-the-market theory by holding that an investor who relies on the integrity of the market in producing information reported in a newspaper has sufficiently

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37. See infra note 94 and cases cited therein.
38. See infra note 95 and cases cited therein.
39. See infra note 94 and cases cited therein. But see infra note 95 and cases cited therein.
41. See Blackie, 524 F.2d at 907-08.
42. Id. Thus, there is some overlap between the fraud-on-the-market theory of recovery and the objective approach to liability in actions involving omissions or nondisclosure affecting the market. In these cases a plaintiff may proceed under either theory. Id. at 906.
43. Id. at 908.
alleged causation for the purposes of withstanding a motion for summary judgment. In *Panzirer*, defendant Allied Artist issued an annual report containing numerous misrepresentations and omissions that had been certified by defendant Price Waterhouse. Zelda Panzirer, who never read the annual report, purchased Allied's stock after reading about the company in the *Wall Street Journal* column, “Heard on the Street.” Six months later, Allied filed for bankruptcy and Panzirer lost her investment. Panzirer filed a class suit under rule 10b-5 against defendants Allied Artist and Price Waterhouse, contending that if the *Wall Street Journal* article had presented Allied in a less favorable light, she would not have made her losing investment. Panzirer asserted that her reliance on the newspaper article amounted to reliance on the integrity of the market.

The district court granted summary judgment to the defendants, finding that Panzirer primarily relied on the *Wall Street Journal* column and placed only secondary reliance on the integrity of the market. The district court held that such secondary reliance would not support a rule 10b-5 claim.

The United States Court of Appeals for the Second Circuit reversed on the issue of reliance. Finding no legal basis for the district court's distinction between primary and secondary reliance, the court of appeals stated that direct reliance on misrepresentations or omissions is not necessary to establish causation. In an opinion by Circuit Judge Lumbard, the court held that a causational link is sufficiently alleged when a rule 10b-5 plaintiff indirectly relies on the misrepresentation or omission by relying

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45. 663 F.2d at 367.
46. Id.
48. Id. The district court also denied Panzirer's motion for class certification on the grounds that she was not a suitable class representative, having asserted no less than three different accounts of the facts precipitating her purchase of stock. Id. at 97,432-37. In a deposition taken by defendants on Nov. 6, 1979, Panzirer claimed that she did not see the annual report and received no other financial information. Rather, she claimed that she bought Allied's stock on the basis of the newspaper article and her conversation with her broker who told her that he knew of “no negative news about Allied.” Id. at 97,431. According to Panzirer's second account of the facts culminating with her purchase, she asserted that her broker read to her from the Standard & Poor tear sheet during their telephone conversation. Id. at 97,432. Her broker testified, however, that the information he read to her from the tear sheet pertained to the video cassette business and that he did not read any financial information about Allied. In her last version of the facts, Panzirer claimed that her broker read about the video business and conveyed information about Allied's earnings, stock price and financial condition. Id. at 97,437. The court of appeals affirmed the district court's denial of class certification. 663 F.2d at 368.
49. 663 F.2d at 367.
50. Id. at 368.
on information from those working in or reporting on the securities markets, when that information is reported after the material misrepresentation or omission has been circulated.\textsuperscript{51}

Both Price Waterhouse and Panzirer appealed the Second Circuit's decision. The Supreme Court granted certiorari to decide whether a rule 10b-5 defendant, who has made an allegedly misleading statement relating to an issuer of corporate securities, can be liable to an individual who purchases the issuer's stock in reliance on a newspaper article that refers to the issuer but not to the defendant or the defendant's statements.\textsuperscript{52} The Court, however, denied Panzirer's petition for certiorari on the class action issue. Having lost all possibility of class certification, Panzirer decided not to pursue her claim and petitioned the Court to dismiss her case as moot. As a result, the Court ordered the Second Circuit to dismiss the case with prejudice.\textsuperscript{53}

This Note first examines the objective approach used to establish causation without requiring proof of direct reliance on misrepresentations. It then discusses the development of and rationale behind the fraud-on-the-market theory and analyzes Panzirer's extension of this theory of recovery. Finally, this Note concludes by exploring the potential ramifications of the Supreme Court's decision to dismiss Panzirer with prejudice.

I. The Objective Approach to Rule 10b-5 Liability

A. The Origins of the Objective Approach

In rule 10b-5 actions where the alleged fraud is either an omission or complete nondisclosure of material facts, requiring proof of reliance would preclude civil recovery and thereby thwart the rule's deterrent effect.\textsuperscript{54} Courts began to modify the reliance requirement in the 1960's to relieve an allegedly defrauded investor of the burden of proving direct reliance on a defendant's silence. Thus, in omission or nondisclosure cases, a plaintiff could satisfy the element of reliance by showing that he would have acted differently had all the material facts been disclosed.\textsuperscript{55}

This method of establishing reliance was first used by the Second Circuit

\textsuperscript{51} Id. at 367.

\textsuperscript{52} 102 S. Ct. 3481 (1982).

\textsuperscript{53} 103 S. Ct. 434 (1982).

\textsuperscript{54} See supra notes 24-31 and accompanying text.

In *List v. Fashion Park, Inc.*, a seller of securities brought a rule 10b-5 action against a corporate officer, alleging that the officer failed to disclose material inside information when purchasing the securities. The district court granted the defendant's motion to dismiss because the investor had not shown actual reliance on the officer's silence and therefore could not establish causation.

The Second Circuit affirmed the district court's finding of nonreliance but stated that the proper test of reliance in nondisclosure cases was not whether the plaintiff relied on the defendant's silence but whether the plaintiff would have acted differently if fully informed. The court held against recovery, even though the nondisclosure was material, because the plaintiff had failed to meet this test of reliance. In reaching this conclusion, the court distinguished between the common law elements of reliance and materiality, noting that while materiality certifies whether the reliance was reasonable, reliance provides the causal link between the fraud and the injury. Although the court admitted that discarding the reliance requirement would facilitate proof of fraud and thus advance the purposes of the rule, it found this to be "an inadequate reason for reading out of the rule so basic an element of tort law as the principle of cause in fact."

Although the *List* formulation of reliance is easier to show than common law reliance, it imposes upon a plaintiff the burden of proving a hypothetical course of conduct. The deficiencies in the *List* test were, however, eliminated in the Supreme Court's decision in *Affiliated Ute Citi*

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57. 340 F.2d at 460-61. One who is privy to nonpublic information by virtue of an agency relationship to a corporate issuer of securities and knows that the material is nonpublic has a duty to refrain from trading, tipping, or recommending the issuer's securities or to disclose that information prior to trading in the securities of the corporation. See Chiarella v. United States, 445 U.S. 222, 227-30 (1980); see also Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); cf. Cady, Roberts & Co., 40 S.E.C. 907 (1961). Tippees, those who receive material nonpublic information from corporate insiders, have a duty not to trade when they know or should know that the information is material nonpublic information that came from an insider. Shapiro, 495 F.2d at 237-38. The Supreme Court is currently reexamining the scope of liability in this context. See Dirks v. SEC, 681 F.2d 824 (D.C. Cir.), cert. granted, 103 S. Ct. 371 (1982). For an extensive analysis of insider trading, see 5A A. Jacobs, supra note 4, at §§ 66.02 & 92.
58. 227 F. Supp. at 911-12.
59. 340 F.2d at 464.
60. Id. at 463.
61. Id. at 462-63.
62. Id.
63. Id. at 463.
64. See R. Jennings & H. Marsh, supra note 5, at 1048, arguing that this test of reliance on omissions is not only hypothetical but also "seems to differ little from the question
zens v. United States. 65

In Affiliated Ute Citizens, a bank and its employees bought stock from a group of unsophisticated security holders with whom the bank had an ongoing business relationship. The bank purchased the stock at a price below market value without disclosing that it was a market maker for the securities and was reselling the stock to other investors at a substantially higher price. The Court found that the bank owed the sellers a fiduciary duty 66 that the bank had breached by failing to disclose material information concerning its activity as a market maker for the stock. 67

The United States Court of Appeals for the Tenth Circuit had held that the plaintiffs could not recover damages under rule 10b-5 because they failed to show reliance on material misstatements. 68 The Supreme Court, however, rejected this restrictive reading of the rule. The Court distinguished between the prohibition against false or misleading statements in clause (b) of the rule and the broader proscriptions in clauses (a) and (c). 69 Finding that the defendants’ behavior could be characterized as a deceptive scheme or course of business actionable under clauses (a) or (c), the Court concluded that the lower court’s requirement of actual reliance was misplaced. 70

Noting that “Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed ‘not technically and restrictively, but flexibly to effectuate its remedial purposes,’” 71 the Court held that:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. 72

There are several ambiguities in the Affiliated Ute Citizens holding of materiality, i.e., would (might?) a ‘reasonable person’ or the ‘average investor’ have considered the information important?”

66. Id. at 153.
67. Id.
69. 406 U.S. at 152-53.
70. Id. at 153.
71. Id. at 151.
72. Id. at 153-54 (quoting Mills v. Electric Auto-Light Co., 396 U.S. 375 (1970) and
which made the decision difficult for the lower federal courts to apply. First, although the Court found the defendants' activity to be primarily a failure to disclose within the proscriptions of rule 10b-5(a) and (c), the case also involved misrepresentations and omissions. While it is possible that the Court's holding is restricted to actions involving complete nondisclosure, lower courts have applied Affiliated Ute Citizens in actions brought pursuant to rule 10b-5(b) for omissions and misrepresentations. Another curious aspect of the Affiliated Ute Citizens holding is the Court's failure to remand the issue of causation to the lower court, indicating that materiality conclusively establishes causation in nondisclosure cases. Courts that have extended Affiliated Ute Citizens to actions involving misrepresentations and omissions in violation of rule 10b-5(b) have held that materiality establishes a "rebuttable presumption of reliance." Finally, although Affiliated Ute Citizens involved a face-to-face transaction, courts have universally extended its coverage to exchange and over-the-counter transactions ("open market" transactions).

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom., Coates v. SEC, 394 U.S. 976 (1979)).

Both Affiliated Ute Citizens and Mills employ a "might" formulation of materiality. Affiliated Ute Citizens, 406 U.S. at 153-54; Mills, 396 U.S. at 385. Compare, TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (an omitted fact is material if a reasonable investor "would" consider the information important when making an investment decision), discussed supra at note 16. That the TSC opinion did not, however, overrule the Affiliated Ute Citizens or Mills formulation of materiality suggests that TSC controls in determining whether a fact is material, whereas the Affiliated Ute Citizens/Mills test is used for determining whether a material omission was the cause-in-fact of a plaintiff's injury.

73. 406 U.S. at 151-52.
74. Id. at 152.
75. E.g., Rifkin v. Crow, 574 F.2d 256 (5th Cir. 1978) (Affiliated Ute Citizens creates a presumption of reliance on alleged material omissions); cases cited infra notes 94 & 95; see also Bell v. Cameron, 669 F.2d 1278 (9th Cir. 1982) (Affiliated Ute Citizens creates a presumption of reliance in cases involving both material misrepresentations and omissions).
77. See, e.g., Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982) (reliance presumed in case involving both misrepresentations and omissions); Rifkin, 574 F.2d at 263 (reliance presumed in omissions cases). For a full discussion of extensions of Affiliated Ute Citizens in actions brought for violations of rule 10b-5(b), see infra notes 93-113 and accompanying text.
78. See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238, 240 (2d Cir. 1974). This construction of Affiliated Ute Citizens is in accord with Mills, 396 U.S. at 385 (proxy rules case involving a class action).
B. Extensions of Affiliated Ute Citizens

1. Nondisclosure Cases in Open Market Transactions

Courts have extended Affiliated Ute Citizens to situations where the alleged fraud involves violations of rule 10b-5(a) or (c), proscribing fraudulent schemes or conduct not involving a face-to-face transaction. The Second Circuit has found the Affiliated Ute Citizens rationale dispositive when there has been a fraudulent scheme resulting in a forced sale of securities at a price below market value. In Schlick v. Penn-Dixie Cement Corp., the defendant, Penn-Dixie, acquired voting control of Continental Corporation. The plaintiff, a minority shareholder in Continental, alleged that the defendant used Continental’s assets so as to enhance the value of Penn-Dixie’s stock and depress the value of Continental’s. The plaintiff further alleged that Penn-Dixie issued proxy statements containing material omissions as to the manner in which Penn-Dixie had reduced the value of Continental’s shares as part of a plan to obtain a favorable exchange ratio when the companies merged. The district court dismissed the minority shareholders’ suit for damages resulting from the unfairly low exchange ratio. The court reasoned that because Penn-Dixie, as Continental’s majority shareholder, had enough voting power to force a merger between the companies, the defendant’s misleading proxy reports could not have caused the plaintiffs to engage in any investment decision.

The Second Circuit reversed on the issue of causation. Relying on Affiliated Ute Citizens, the court reasoned that if the case were based solely on misrepresentations and omissions in the proxy statement, then the plaintiff would have to show “both loss causation—that the misrepresentations or omissions caused the economic harm—and transaction causation—that the violations in question caused the [plaintiff] to engage in the [particular] transaction.” In order to prove transaction causation a plaintiff must

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79. See supra note 78.
81. Id.
82. Id. at 376-77.
84. Id. Under Indiana law, a majority vote of the outstanding shares of stock of a corporation will secure shareholder approval of a merger. IND. CODE ANN. tit. 23, art. I, ch. 5, § 2(b) (Burns 1972). Since Penn-Dixie could legally force Continental’s minority shareholders to forfeit ownership rights, the lower court determined that the misleading proxy statement did not cause plaintiffs’ sale. The district court concluded that plaintiffs’ inability to establish a causal connection between the fraud and the transaction defeated their rule 10b-5 claim because they failed to prove the element of reliance. Id.
85. 507 F.2d at 380 (emphasis supplied).
have relied on misrepresentations or omissions. The court held that where the alleged fraud involves the effectuation of a scheme to defraud, including not only misrepresentations and omissions but also market manipulation and a merger on preferential terms, a plaintiff need only show loss causation in order to recover. 86

The Second Circuit has suggested that this theory may apply when there is a scheme to defraud but no forced sale. In Competitive Associates v. Laventhal, 87 the Second Circuit interpreted Schlick as holding that “reliance is not required where a comprehensive scheme to defraud which includes not only omissions and misrepresentation, but substantial collateral conduct as well, is alleged.” 88 In Competitive Associates, an investment manager allegedly mishandled the plaintiffs’ funds. The investment manager had previously mismanaged other funds but had covered up his activities by allegedly falsifying financial statements that the defendant accountants had certified. The plaintiff brought a rule 10b-5 action alleging that the accountants certified the statements as part of a scheme to attract investors to the investment management company by inflating the reputation of the investment manager, thereby creating a “dumping ground” for the securities he was manipulating. 89 The district court granted summary judgment to the defendant accountants because the plaintiff never saw the misleading reports, and therefore, in the court’s view, could not have relied on them. 90

The Second Circuit reversed, stating that a plaintiff need only show causation in fact when, as in Schlick, “both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud.” 91 The court reasoned that the fact that the plaintiff never saw the annual reports is inapposite to the issue of causation because under a Schlick-Affiliated Ute Citizens analysis the plaintiff need not prove transaction causation, but only that the fraud caused the alleged loss. 92

2. Extensions of Affiliated Ute Citizens to Cases Involving Omissions

Although Affiliated Ute Citizens involved “primarily a failure to disclose” material facts, 93 it has been applied in omission cases arising under

86. Id. at 381.
87. 516 F.2d 811 (2d Cir. 1975).
88. Id. at 814.
89. Id. at 812-13.
90. Id. at 813.
91. Id. at 814.
92. See supra notes 76, 85-86 and accompanying text.
93. 406 U.S. at 153-54. Nondisclosures are distinguishable from omissions. Nondisclosure cases involve complete silence, whereas omission cases involve a statement accurately
In order to limit recovery to those situations where a violation of the rule is the cause in fact of the injury, courts have interpreted *Affiliated Ute Citizens* as establishing a rebuttable presumption of reliance on the alleged omissions. The Fifth Circuit’s decision in *Rifkin v. Crow* illustrates this interpretation of *Affiliated Ute Citizens*. In *Rifkin*, plaintiff brought a rule 10b-5 class action against Recognition Equipment, Inc., seeking recovery of damages allegedly caused by annual and interim reports containing misrepresentations and omissions as to the company’s financial condition. The plaintiff argued that these misrepresentations and omissions inflated the price of the stock, and that class members purchasing stock at the inflated value incurred a loss when the company’s true financial condition was disclosed. Granting the defendants’ motion to dismiss, the district court found that plaintiffs never saw the annual report containing the misrepresentations and omissions and thus could not have relied on them.

The Fifth Circuit remanded the case on the issue of reliance. The court stated that if the district court finds that this is a misrepresentation case, the plaintiffs have the burden of proving reliance on the misleading reports. If, however, the district court finds that the fraud may be “characterized” as an “omission,” then the plaintiff is entitled to the *Affiliated Ute Citizens* presumption of reliance that the defendants carry the burden of disproving.

disclosing some information but misleading the listener or reader by concealing other information. *See supra* note 25.


95. *See* cases cited *supra* note 94. *See also* *Bell v. Cameron*, 669 F.2d 1278 (9th Cir. 1982); *Austin v. Loftsgaarden*, 675 F.2d 168, 178 n.21 (8th Cir. 1982); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 188 (3d Cir. 1981); *Shores v. Sklar*, 647 F.2d 972 (5th Cir. 1981), *cert. denied*, 51 U.S.L.W. 3508 (U.S. Jan. 10, 1983); *Panter v. Marshal Field & Co.*, 646 F.2d 271, 284 (7th Cir. 1981); *Carothers v. Rice*, 663 F.2d 7 (6th Cir. 1980); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975); *Carras v. Burns*, 516 F.2d 251, 255 (4th Cir. 1975).

In *Affiliated Ute Citizens*, the Court held that a materiality of nondisclosure established causation. 406 U.S. at 151-52; *see supra* note 73 and accompanying text.

96. 874 F.2d 256 (5th Cir. 1978).

97. *Id.* at 258-60.

98. *Id.* at 260-61.

99. *Id.* at 262.

100. *Id.* at 263.

101. *Id.* District Judge Taylor determined, on remand, that it would be impossible to make a sound investment decision after reading a financial statement containing material
3. Extension of Affiliated Ute Citizens Whenever Reliance is Difficult to Prove

Several circuits have interpreted Affiliated Ute Citizens as establishing a rebuttable presumption of reliance when there has been a general assertion that may be viewed as a misrepresentation or omission.102 The Third Circuit’s decision in Sharp v. Coopers & Lybrand103 exemplifies this approach. In Sharp, purchasers of limited partnership interests in an oil and gas drilling venture brought a class action suit against an accounting firm that had prepared an opinion letter dealing with the tax treatment of the investments. The plaintiffs alleged that the defendant’s opinion letter contained numerous misrepresentations and omissions in violation of rule 10b-5, that the opinion letter caused them to invest in the venture, and that they lost their investment when events did not proceed as represented in the letter.104

Defendant appealed the judgment for the plaintiff, arguing that the trial court erred in creating a presumption that the class representative relied on the misrepresentations and omissions in the opinion letter.105 The defendant contended that because this was a misrepresentation case, the plaintiff carried the burden of proving reliance.106 The Third Circuit rejected a strict application of the omissions-misrepresentations dichotomy, however, and embraced the position that reliance should be presumed “when it is logical to do so.”107 The court thus adopted a more flexible approach to reliance, requiring determination of “the most reasonable placement of the burden of reliance” on a case-by-case basis.108 The court concluded that distinguishing between misrepresentations and omissions in the case at hand would be illogical because it would require a dual jury instruction.109

103. 649 F.2d 175 (3d Cir. 1981); cert. denied, 102 S. Ct. 1427 (1982).
104. Id. at 178-79.
105. Id. at 187.
106. Id.
107. Id. at 188 (quoting Lewis v. McGraw, 619 F.2d 192, 195 (2d Cir. 1980), cert. denied, 449 U.S. 951 (1980)).
108. Id. at 188.
109. Id. Judge Aldisert stated: “The jury would be instructed to search for proof of reliance by the plaintiff with regard to misrepresentations, and to search for proof of nonreli-
As the *Sharp* decision indicates, courts have interpreted the rule 10b-5 reliance requirement flexibly. Courts have extended *Affiliated Ute Citizens* to open market transactions involving nondisclosures,110 omissions,111 and complex combinations of misrepresentations and omissions.112 To restrict the potentially limitless liability under the rule, however, courts have permitted a defendant to prove that the deceptive misrepresentations or omissions did not in fact induce the plaintiff to enter into the allegedly injurious transaction.113

II. THE FRAUD-ON-THE-MARKET THEORY OF RECOVERY

A fraud-on-the-market theory of liability has developed in the lower federal courts allowing an investor who purchases or sells securities under the assumption that the market is free from fraud to recover losses resulting from rule 10b-5 violations that have caused the market to generate inaccurate information about the particular security.114 The fraud-on-the-market theory was first used in cases involving fraud that had inflated the price of a security, and an unsuspecting investor had bought the security after relying on the price of the particular security as an indication of its inherent value. Once the truth about the issuer became public and the price of its securities decreased, these investors suffered a loss, even if they never saw or heard the fraudulent remarks made by or on behalf of the issuer.115

Recognizing that these investors had incurred damage as a result of a rule 10b-5 violation, some courts have held that investors who purchased or sold securities in reliance on the integrity of the market price, after material misrepresentations or omissions inflated or deflated the price of the securities, have circumstantially established causation.116 This theory assumes that reliance on market price amounts to indirect reliance on the representations underlying that price.117

Recently, the fraud-on-the-market theory has been extended for the

110. *See supra* notes 79-92 and accompanying text.
111. *See supra* notes 93-101 and accompanying text; *supra* note 95 and cases cited therein.
112. *See supra* notes 102-09 and accompanying text.
113. *See supra* note 102 and cases cited therein.
114. *See supra* note 40 and cases cited therein.
115. *See infra* notes 129-52 and accompanying text.
116. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); *see also infra* notes 136-51 and accompanying text.
117. *See Blackie*, 524 F.2d at 907.
benefit of investors who rely on the integrity of the market in bringing into the market securities that are entitled to be issued. The most expansive reading of the fraud-on-the-market theory to date allows an investor who relies on the integrity of the market in producing information reported in a newspaper article to recover damages in an action brought pursuant to rule 10b-5.

A. Development of the Fraud-on-the-Market Theory

I. "Derivative Reliance"

The notion that indirect reliance on material misstatements or omissions satisfies the reliance element in rule 10b-5 actions predates both the objective and "fraud-on-the-market" theories of recovery. "Derivative" reliance, or reliance on others who have relied, has been recognized as a valid form of reliance in actions involving forced sales of securities.

In Vine v. Beneficial Finance Co., the Second Circuit first articulated an indirect reliance standard in a rule 10b-5 action. In Vine, a class B shareholder in Crown Co. was forced to sell his stock pursuant to a short form merger with Beneficial Financial Company. The seller alleged that as a result of the fraudulent scheme perpetrated on Crown's class A shareholders, Beneficial acquired voting control of Crown, effected a merger, and thereby placed the class B shareholders in the position of a forced seller.

The Vine court held that proof of reliance is not required in a rule 10b-5 action "when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer." To establish causation, the Vine court required only that there be deception that misled class A shareholders and that their deception was the cause in fact of the plaintiff's injury.

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120. For recent cases using this approach, see 5A A. JACOBS, supra note 4, at § 64.01[b][ii] n.68.
121. 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).
122. A short form merger statute authorizes a corporation owning a high percentage of the outstanding shares of another corporation to merge the latter corporation into the former without the authorization of the minority shareholders of the merged corporation.
123. 374 F.2d at 635.
124. Id.
125. Id.
In *Crane v. Westinghouse Air Brake Co.*, the Second Circuit extended the *Vine* decision to an action involving fraud in connection with the solicitation of tender offers. In *Crane*, an unsuccessful contestant for control of Air Brake sued its competitor, alleging that the defendant manipulated the price of Air Brake stock on the open market and made false and misleading statements to Air Brake shareholders for the purpose of preventing a merger between the plaintiff and Air Brake. The court reiterated its position in *Vine* that proof of direct reliance on misstatements or omissions is unnecessary where there has been no volitional act, but found that the defendant's act of concealing material information from the investing public caused the price of stock to artificially rise, resulting in the plaintiff's damage.

2. The Inflated Market Price Theory of Recovery

The *Crane* court's position that direct reliance on misrepresentations or omissions is not necessary when the alleged fraud has manipulated the price of stock was developed further in the 1970's in class actions brought pursuant to the rule. Direct subjective reliance, as required by common law and early rule 10b-5 suits as a prerequisite to causation, presented a formidable obstacle to the use of the class action device in rule 10b-5 suits. In order to avoid cumbersome separate trials on the issue of reliance as to each class member or outright denial of class certification, courts have focused on the relationship between the fraud and the loss rather than the connection between the violation and the purchase or sale.

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127. Id. at 790-97.
128. Id. at 797.
130. See *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968) (bifurcation of a rule 10b-5 class action ordered, allowing class certification of common question of wrongfulness and materiality and allowing separate trial on the issue of reliance as to each class member if common elements of liability are found); cf. *Siegel v. Realty Equities Corp.*, 54 F.R.D. 420 (S.D.N.Y. 1972) (determination of whether to order separate trials on the issue of reliance is up to the trial judges).
131. See *In re Memorex Sec. Cases*, 61 F.R.D. at 98: "If actual individual reliance in its common law sense need be proved by each class member, the trial of that issue . . . would tax the courts' (and counsels') resources to an intolerable extent." Thus, individual questions of reliance would predominate over common issues of wrongfulness and materiality of misrepresentation, thereby mandating denial of class certification.
132. See cases cited supra note 129.
In *In re Memorex*, plaintiffs filed a motion for class certification of a rule 10b-5 action. Defendant argued that the motion should be denied on the grounds that individual questions of reliance predominated over common issues. Finding that a new concept of reliance had developed, freeing the court from the overwhelming burden of examining each class member's subjective intent at the time of the transaction, the court certified the class. According to the court, this modern concept of reliance "focuses on a 'causal nexus' between the alleged misstatements and an inflated price upon which the plaintiffs relied."

**B. The Fraud-on-the-Market Theory**

In *Blackie v. Barrack*, the Ninth Circuit fully articulated a theory of liability that both focuses on the causal relationship between the fraud and an inflated price and seeks to determine whether third persons have directly relied on alleged misstatements or omissions so as to artificially manipulate the price of stock. The *Blackie* theory also embodies principles of the objective theory. The materiality of omitted or misrepresented facts establishes a presumption that other investors have relied, thereby circumstantially establishing a causal relationship between the fraud and the inflated market price.

In *Blackie*, defendant issued a series of annual reports misrepresenting the company's true financial condition. After the defendant made full public disclosure of the company's unhealthy financial outlook, several suits were filed against the company for violating the antifraud provisions of rule 10b-5. The plaintiffs claimed that the defendant artificially inflated the price of the company's stock by its misleading annual and interim reports, press releases, and SEC filings. Upon disclosure of the company's true financial condition, the value of the stock declined and the plaintiffs incurred a loss.

In response to the defendant's contention that the plaintiffs could not recover without proving direct reliance, the Ninth Circuit stated that

134. *Id.* at 97-98.
135. *Id.* at 98-99.
136. *Id.* at 100.
137. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).
138. *Id.* at 907; *see also* cases cited supra note 40.
139. 524 F.2d at 906.
140. *Id.* at 894, 902.
141. *Id.* at 906. Defendants also argued that plaintiffs' motion for class certification be dismissed, asserting that individual issues of reliance predominated over common questions of materiality of misrepresentation. *Id.* at 894. Relying on *In re* Memorex Sec. Cases, 61
"reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market." The court held that:

[causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations. . . . Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between the defendant's conduct and the plaintiff's loss is sufficiently established to make out a prima facie case.]

The court reasoned that investors purchasing securities in the open market on the basis of favorable price indicia rely on the assumption that the market price is validly set and that no fraud has altered the price. The investor thus indirectly relies on the truth of the representations underlying the stock prices. An investor who has no actual knowledge of the misrepresentations or omissions may be injured by the fraud if enough investors have relied so as to inflate the price of the stock and cause the plaintiff's losing purchase.

The court noted that, in these circumstances, requiring reliance "impose[s] an unreasonable and irrelevant evidentiary burden . . . [that would] lead to underinclusive recoveries and thereby threatens the enforcement of the securities laws." Recognizing that rule 10b-5 is designed to foster an expectation that the securities markets are free from fraud, the court refused to leave unprotected those investors who rely on the integrity of the market in generating price information.

F.R.D. 88 (N.D. Cal. 1973) and In re U.S. Financial Sec. Litig., 64 F.R.D. 443 (S.D. Cal. 1974), the court found that individual reliance is not necessary in class actions where fraud affects the price of securities. See supra notes 128-35 and accompanying text. Blackie, however, goes beyond the plaintiffs' rationale for holding direct reliance unnecessary in these circumstances. See infra notes 142-51 and accompanying text.

142. 524 F.2d at 906.
143. Id. As an alternative holding, the court found that Affiliated Ute Citizens, 406 U.S. 128 (1972), would also apply in this case to establish a presumption of reliance because the fraud can be characterized as a material omission. See supra notes 93-101 and accompanying text. Thus, when a complaint alleges a material omission affecting the price of stock, a plaintiff may proceed by either an Affiliated Ute Citizens theory or a fraud-on-the-market theory. Id. at 905-06; accord Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).
144. 524 F.2d at 907.
145. Id.
146. Id.
147. Id. at 907-08.
148. Id. at 907.
149. Id.
Thus, under the Blackie approach, when fraud has affected the price of securities, direct actual reliance is not necessary for recovery. The Blackie court determined that a material misrepresentation or omission, causing an inflation of the price of securities, with subsequent reliance on price by the plaintiff, proves causation. As the Ninth Circuit noted, this theory rests on the "common sense" notion that a plaintiff does not ordinarily seek to incur a loss by purchasing securities at an inflated price. In order to ensure that a causal relationship exists between the defendant's misconduct and the plaintiff's loss, the Blackie court provided two ways that a defendant may disprove causation: "(1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and (2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it."  

B. The "Fraudulent Issuance of Securities" Theory

The most recent variation of fraud-on-the-market theory of liability, brought about by the Fifth Circuit in Shores v. Sklar, allows a plaintiff to recover without showing direct reliance if the security would not have been issued but for the defendant's fraudulent scheme. Under this theory, a plaintiff may recover by proving that the defendant knowingly brought worthless securities into the market, that the plaintiff reasonably relied on the integrity of the market in making available genuine securities, and that the plaintiff suffered a loss resulting from the fraudulent scheme. Moreover, the defendant may not rebut the plaintiff's case by proving nonreliance on misleading statements or omissions.

In Sklar, an Industrial Development Board issued revenue bonds for the development of a mobile home facility. The Board secured a lease of the premises, in order to authorize the issuance of, and pay the interest obligations on, the bonds. The defendant, an attorney who acted as bond coun-

150. Id. at 908.
151. Id.
152. Id. at 906. The court noted that the weight of authority favors a rebuttable presumption of reliance. Id. at 906 n.22. The court doubted, however, that an opportunity to rebut the presumption of reliance "[would] substantially reduce a defendant's liability in the open market fraud context" because it is "[doubtful] that a defendant would be able to prove . . . that a plaintiff was indifferent to a material fraud." Id. at 906-07 n.22. Nevertheless, the court felt that public policy is best served by "limiting recoveries to those who are in fact injured, and excluding those whom a defendant proves have not been injured . . . ." Id. at 907 n.22. Accord Little v. First Cal. Co., 532 F.2d 1302, 1304 n.4 (9th Cir. 1976).
154. 647 F.2d at 469-70.
155. Id.
sel, drafted an offering circular containing material misrepresentations and omissions about the lessee's ability to meet its obligations under the lease. The plaintiffs purchased the bonds, the lessee defaulted on its payments, and the entire project failed. Although the plaintiffs never saw the offering circular, they brought a rule 10b-5 action against the defendant. They alleged that the defendant and others devised a scheme to defraud the investing public in contravention of the securities laws by way of a materially misleading offering circular that induced the board to issue, and the public to buy, "fraudulently marketed bonds."\textsuperscript{156}

The United States Court of Appeals for the Fifth Circuit stated that if this were a case solely involving misrepresentations and omissions under rule 10b-5(b), then the \textit{Affiliated Ute Citizens} presumption of reliance had been successfully rebutted by the plaintiff's admitted lack of reliance on the offering circular.\textsuperscript{157} The court held that summary judgment was inappropriate in this case, however, because the plaintiff "alleged the necessary elements under 10b-5[(a)] or [(c)]" for deceptive scheme or acts.\textsuperscript{158} The majority stated that the purpose of rule 10b-5 in promoting "free and honest securities markets" justified this conclusion.\textsuperscript{159}

A vigorous dissent by Circuit Judge Randall accused the majority of creating a new theory of liability that would defeat the primary purpose of the rule—"the making of an informed investment decision"—by permitting an investor who has not "elected . . . to seek to read what the seller is obligated by the Rule to disclose" to recover damages.\textsuperscript{160} The dissent emphasized the need to limit the rule's judicially created private right of action\textsuperscript{161} and the Supreme Court's "concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good."\textsuperscript{162} As a final policy concern, the dissent argued that the majority's decision will protract rule 10b-5 litigation in the federal courts that should otherwise have been resolved at the summary judgment stage.\textsuperscript{163}
The dissent also found the majority's distinction between sections (a), (b), and (c) of rule 10b-5 to be utterly lacking in precedent. The dissent stated that the majority's search for causation whenever the fraud alleged "shifts from misrepresentation or omission in a document to fraud on a broader scale" was a maneuver designed for the purpose of "[avoiding] the result . . . mandated by the application . . . of the traditional elements of a private cause of action under rule 10b-5." According to the dissent, the only type of case where nonreliance as a rebuttal presumption should not be permitted is in cases, such as *Schlick v. Penn-Dixie Cement Corp.*, where there is fraud in connection with a forced sale in which a plaintiff has no opportunity to make an investment decision.

The difference of opinion between the majority and dissent in *Sklar* is illustrative of the ultimate dilemma in fraud-on-the-market cases. On the one hand, the purpose of the rule is to protect investors and ensure the integrity of the market. Courts are thus reluctant to deny rule 10b-5 recovery to private investors who have not directly relied on misstatements or omissions but who have incurred a loss as a result of fraud affecting the securities market. On the other hand, if the securities laws are designed to promote knowledgeable investment decisions, it might be inappropriate to compensate investors who do not avail themselves of the disclosure documents required by the securities laws.

III. *PANZIRER v. WOLF*: EXTENDING THE FRAUD-ON-THE-MARKET THEORY

The Second Circuit's decision in *Panzirer v. Wolf* extends the fraud-on-the-market theory so that investors who rely on newspaper accounts of corporate issuers of securities may recoup losses when there have been material misrepresentations or omissions in violation of rule 10b-5. In

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165. *Id.* at 485. The dissent viewed the effect of the majority's decision as permitting a plaintiff whose case is covered by clause (b) to rely on the provisions of clauses (a) or (c) in order to circumvent the reliance requirement of clause (b), thereby rendering that clause "a dead letter in the one situation in which it most typically applies—the offering of a security, pursuant to an offering circular, to investors who are called upon to make routine investment decisions." *Id.* at 486. The dissent felt that the majority's approach would lead to a transformation of the rule into a form of investor's insurance and an elimination of all the traditional requirements of proof in a cause of action under the rule. *Id.* at 486.

166. *Id.* at 479-81. For a full discussion of *Schlick*, see *supra* notes 80-86 and accompanying text.


168. 663 F.2d at 367.
Panzirer, plaintiff brought a rule 10b-5 action against Allied Artists and Price Waterhouse alleging that the plaintiff made a losing purchase of stock resulting from misrepresentations and omissions in Allied's report of profits for a year in which it actually incurred a loss. The primary omission was Price Waterhouse's failure, as Allied's accountants, to qualify the annual report by stating its doubts as to the company's ability to continue as a going concern.169

Although Panzirer never saw the misleading annual report, she read about the company in a Wall Street Journal column, "Heard on the Street," which favorably presented Allied's decision to enter the video cassette market.170 Since Panzirer was a substitute school teacher at the time, the item on the educational use of video cassettes caught her eye. After reading the article, she phoned her broker, asking him if he had any negative news on Allied. The broker stated that he did not follow Allied, but after glancing at a Standard & Poor's tear sheet, told her that he did not know of any negative news. Panzirer bought 200 shares of Allied common stock. Shortly thereafter, Panzirer raised her order to 500 shares.

The court of appeals determined from the record that Panzirer's decision to invest in Allied was not influenced by the price of the stock or her conversation with her broker.171 Panzirer claimed, rather, that by relying on the integrity of the market in producing information reported in the Wall Street Journal, she indirectly relied on the annual report.172 She thus alleged a four part causational chain: "If Allied's report had been accurate, the stock analysts interviewed by the Journal would not have mentioned the company favorably, the Journal would not have devoted two paragraphs to Allied's prospects... and [she] would not have been led by

169. Id.
170. Marcial, Prospects for New Home Video Equipment Spark Analyst Optimism About the Industry, Wall St. J., Sept. 29, 1978, at 47, col. 3. Relevant portions of the article are as follows:

Several analysts contend that Allied Artists is in a good position to take advantage of the growing demand for video tapes, having pioneered the development of prerecorded cassettes.

Andrew G. Raez, of Philips, Appel & Walden, Inc., says Allied Artists, besides having a head start in video tapes and cassettes, is negotiating with TV networks, other film producers and makers of educational films to put their films on video cassettes. 'The educational and informational area constitutes a tremendous market for video cassettes.' says Mr. Raez, adding: 'We continue to be bullish on Allied Artists. It's an attractive, turnaround situation.'

171. 663 F.2d at 367. Panzirer asserted three versions of the facts precipitating her purchase. See [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,363 at 97,430-37. These three versions of the facts are set forth supra note 48.
172. 663 F.2d at 367.
the article to buy her stock."\textsuperscript{173}

Price Waterhouse and Allied argued that the allegedly false financial statements were unrelated to the third party statements about the company's prospects in the video cassette market as reported in the \textit{Wall Street Journal}, and therefore could not have induced Panzirer's purchase.\textsuperscript{174} In the alternative, they argued that even if Panzirer is entitled to a presumption of reliance under an extension of \textit{Affiliated Ute Citizens} to cases involving misrepresentations and omissions, that presumption of reliance was rebutted by Panzirer's admission that she neither read nor heard the information in the annual report.\textsuperscript{175} Finally, defendants argued that Panzirer could not proceed under a fraud-on-the-market theory since she relied on a source other than the market price of Allied's stock.\textsuperscript{176} District Court Judge Motley, agreeing with defendants' position that any presumption of reliance under an \textit{Affiliated Ute Citizens} or fraud-on-the-market theory had been rebutted, granted defendants' motion for summary judgment.\textsuperscript{177}

The United States Court of Appeals for the Second Circuit reversed, holding that Panzirer's complaint sufficiently stated a causal nexus between her loss and the annual report to withstand a motion for summary judgment.\textsuperscript{178} While recognizing that the element of reliance serves to limit the plaintiff class to those investors who are in fact injured by the fraud, Judge Lumbard determined that the fraud need only be a "substantial" or "significant contributing cause" of a rule 10b-5 plaintiff's reliance.\textsuperscript{179} In support of its conclusion that Panzirer, who never saw the allegedly fraud-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{173} Id.
\item \textsuperscript{174} [1979-1980 Transfer Binder] \textit{FED. SEC. L. REP. (CCH)} ¶¶ 97,363, 97,436-37. See Price Waterhouse's Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit, file 1982, at 9-10: "We emphasize what is \textit{not} involved in this case. The decision below did \textit{not} involve a claim of liability based upon reports in the media repeating, summarizing or referring to the issuer's allegedly false financial statements or to the independent accountants' opinion thereon." (emphasis added).
\item \textsuperscript{175} [1979-1980 Transfer Binder] \textit{FED. SEC. L. REP. (CCH)} ¶¶ 97,251, 97,267.
\item \textsuperscript{176} Id. ¶ 97,363, at 97,436:

Plaintiff relied on a newspaper article concerning Allied's video cassette business and a discussion with her broker, also concerning Allied's video cassette business. Neither plaintiff nor her broker had read the 1978 Annual Report; moreover, neither plaintiff nor her broker had read the 'tear sheet's' financial information regarding Allied. While plaintiff relied, in part, upon a discussion with her broker, this discussion did not concern Allied's financial statements or condition. Thus, there is no genuine issue as to whether plaintiff relied primarily on another source; the record shows that the presumption of reliance has been rebutted.
\item \textsuperscript{177} Id.
\item \textsuperscript{178} 663 F.2d at 367.
\item \textsuperscript{179} Id.
\end{itemize}
\end{footnotesize}
ulent document, had sufficiently alleged cause in fact, the court reasoned that “[a]s in Competitive Associates, the fact that [Panzirer] must trace her reliance on defendant's alleged fraud through the reactions of third parties does not vitiate her claim under Rule 10b-5.”

Having found that Panzirer need not prove direct reliance, the court cited Affiliated Ute Citizens as establishing a presumption of reliance and supporting the theory that direct reliance is no longer necessary when fraud causes an investor's loss through its effect on the market price of securities. Thus, Judge Lumbard asserted that under the Blackie fraud-on-the-market theory, “the materiality of a fraud creates a presumption of reliance through its presumed effect on the market” permitting a finding of causation.

The court found the Blackie rationale dispositive even though Panzirer relied on the “integrity of the market in producing information reported in The Wall Street Journal” and not on the “integrity of the market price.” Justifying its extension of Blackie, the court reasoned that “[j]ust as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information [reported in The Wall Street Journal].”

IV. PANZIRER: EXPANDING THE SCOPE OF RULE 10b-5 LIABILITY

Panzirer illustrates the problems and confusion courts encounter in attempting to define the element of reliance and its relationship to materiality and causation in modern rule 10b-5 litigation. The court recognizes that the traditional purpose of the reliance requirement is “to permit only those injured by fraud to sue,” but it also points out that direct reliance on material misrepresentations and omissions is no longer a prerequisite to establishing causation in every private right of action brought pursuant to the rule. The Panzirer court fails, however, to distinguish between the various theories that have developed over the years to relieve plaintiffs of

180. Id. at 367-68.
181. Id. at 368.
182. Id.
183. Id.
184. Id.
185. Id.
186. Id. at 367 (citing Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981)).
187. Id. at 368 (“[J]ust as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information [reported in The Wall Street Journal].”)
the burden of proving direct reliance and the factual contexts that have rendered proof of direct reliance inappropriate.

The Panzirer court sought support for its holding in the Competitive Associates decision,\(^\text{188}\) which unlike Panzirer, involved an unlawful scheme to defraud of which misrepresentations and omissions were only one aspect.\(^\text{189}\) In Competitive Associates, the plaintiff’s nonreliance on the misleading annual report was arguably unrelated to the fact that the defendant’s scheme induced the plaintiff to retain the investment management company.\(^\text{190}\) In Panzirer, however, no such collateral conduct was proven—the alleged violation was solely the misrepresentations and omissions in the annual report. In cases where the alleged fraud is the misrepresentation and omission of material fact in violation of rule 10b-5(b), even the most expansive interpretations of Affiliated Ute Citizens have left room for a rebuttal of the reliance presumption by permitting a defendant to prove that the plaintiff did not rely on the deceptive comments.\(^\text{191}\) Even if Panzirer is entitled to a presumption of reliance under the objective theory of liability, that presumption was rebutted by her own admission that she neither read nor heard the allegedly fraudulent misrepresentations or omissions in the annual report.\(^\text{192}\)

Moreover, Panzirer is not wholly consonant with the fraud-on-the-market theory of recovery. Even though Panzirer may have been able to prove that defendants’ misrepresentations and omissions were material and that the price of stock was thereby artificially inflated, she could not recover under Blackie because she did not rely on the price of stock when making her investment decision.\(^\text{193}\) In order to allow Panzirer to litigate her claim, the court has extended the fraud-on-the-market theory to plaintiffs who rely on the accuracy of statements made by those working in or reporting on the securities markets.\(^\text{194}\)

The Panzirer court’s extension of Blackie to situations where fraudulent comments affect newspaper reporting by way of analogy,\(^\text{195}\) seems convincing at first blush. While this approach recognizes the far reaching effect that a fraudulent statement may have, it fails to account for the difference between reliance on price and reliance on newspapers in con-

\(^{188}\) 516 F.2d 811 (2d Cir. 1975); see supra notes 87-92 and accompanying text.

\(^{189}\) 516 F.2d at 814.

\(^{190}\) Id.; see supra notes 91-92 and accompanying text.

\(^{191}\) See Sharp v. Coopers & Lybrand, 649 F.2d 175, 188 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982); see also supra notes 102-113 and accompanying text.

\(^{192}\) See supra note 48 and accompanying text.

\(^{193}\) Id.

\(^{194}\) 663 F.2d at 367.

\(^{195}\) Id. at 368.
connection with the purpose of the securities laws. Price is an integral aspect of the securities markets. The price of stock provides a rational basis upon which investment decisions may be made. If the securities laws are designed to protect investors and create confidence in the nation's securities markets, then it is consistent with congressional intent to punish and prevent deceptive activities that manipulate securities prices.\footnote{196. See supra note 4 discussing the underlying purposes of the rule; see also supra notes 8-11.}

When a plaintiff purchases stock at an artificially inflated price it may be reasonable to eliminate the burden of proving actual reliance as a prerequisite to establishing causation. In these circumstances, the "causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock."\footnote{197. Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); see also supra notes 150-52 and accompanying text.} While common sense may tell us that it is reasonable to assume that an investor relies on price, that same common sense tells us that it is unreasonable to make investment decisions based on comments as reported in the newspaper.

On the other hand, the Panzirer court's extension of the fraud-on-the-market theory realistically appraises the role of full and accurate disclosure as a policy underlying section 10(b) and rule 10b-5.\footnote{198. See supra note 4.} Panzirer recognizes the importance of full disclosure of information, as did the dissent in Sklar,\footnote{199. See supra notes 160-66 and accompanying text.} by imposing liability on those who issue material misstatements or omissions that may influence investment decisions through the media. Unlike the dissent in Sklar, however, the Panzirer court implicitly acknowledges the fact that the highly technical information required to be disclosed under the securities laws is incomprehensible to the ordinary investor. Consequently, this information is normally communicated indirectly to the ordinary investor through recommendations by industry professionals.\footnote{200. See H. Kriple, THE SEC AND CORPORATE DISCLOSURE 14, 22, 27-28 (1979).}
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complete and accurate. In other words, Panzirer relied on a Wall Street Journal article that relied on analysts who relied on the annual report. Even though Panzirer offered no evidence that the analysts actually relied on the annual report and that her reliance must be traced through two intermediaries, the court concluded that the allegedly fraudulent annual report was a "substantial factor" in Panzirer's purchase of Allied's stock.

The court used a Blackie analysis to justify this conclusion, finding that the materiality of misrepresentations or omissions establishes "a presumption of reliance through its presumed effect on the market." In Blackie, plaintiffs relied on the integrity of market price and thus indirectly on the truthfulness of the statements underlying the price. The materiality of the misrepresentations and omissions established a presumption that other traders relied on the statements, thereby providing a causal link between the fraud and the inflated price. When plaintiffs purchased at the inflated price, the causational chain between the fraud and the loss was complete. In order to ensure that only those injured by the fraud may recover damages, the Blackie court provided the defendant with an opportunity to rebut the presumption of causation by showing that an insufficient number of traders relied on misinformation so as to inflate the price.

While the Panzirer court afforded Price Waterhouse and Allied Artists an opportunity to challenge the causational chain during a trial on the merits, its decision may have an adverse impact on analysts and reporters. In order to rebut the Panzirer's prima facie showing of causation, defendants would have to prove that the stock analysts interviewed by The Wall Street Journal did not rely on the annual reports. Analysts voicing opinions to the press and reporters may become subject to extensive discovery as well as exposure to rule 10b-5 liability for allegedly unsubstantiated statements. The net result may be an unwillingness on the part of analysts to disseminate information to the public through the media and a chilling effect on the media's right to report on issuers and their securities.

V. CONCLUSION

The Panzirer court has extended the fraud-on-the-market theory to permit a plaintiff with an attenuated causal connection between a losing

201. 663 F.2d at 367.
202. Id.
203. Id. at 368.
204. Blackie, 524 F.2d at 906. See supra notes 140-55 and accompanying text.
205. 524 F.2d at 906-07 n.22. See supra note 152 and accompanying text.
206. 663 F.2d at 367.
purchase of stock and an allegedly misleading annual report, to survive a motion for summary judgment. Thus, *Panzirer* seems to serve public policy by recognizing that ordinary investors make use of the securities laws' disclosure policy through communications with securities professionals.

On the other hand, *Panzirer* broadens the potential class of plaintiffs who may sue, ultimately resulting in protraction of rule 10b-5 litigation in the federal courts that could otherwise be resolved at the summary judgment stage.\(^2\)

Moreover, *Panzirer* potentially enlarges the potential plaintiff class to those purchasers or sellers who read the newspaper or have contact with those working in the securities market. Thus, it may make an issuer's or accountant's liability dependent upon third party recommendations. In doing so, *Panzirer* weakens the causational link between the allegedly violative behavior and the plaintiff's loss. The decision also brings both analysts quoted by the press and the press itself into the arena of rule 10b-5 litigation and liability. *Panzirer* thus raises important policy issues that the Supreme Court may have to resolve at a later date.

Julie A. Heisel

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207. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975); *see also supra* notes 12 & 162 and accompanying text.