

Loss Causation: Exposing a Fraud on Securities Law Jurisprudence

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I. INTRODUCTION

After creating the idea of “loss causation”¹ in federal securities law cases, the federal courts have called the concept “ungainly,”² “exotic,”³ “confusing,”⁴ and even “unhappy.”⁵ One federal court has recognized that the full application of “loss causation” to civil actions filed under Securities and Exchange Commission Rule 10b-5⁶ would entirely “eviscerate” that primary antifraud provision.⁷ Still, the federal courts have uniformly concluded or assumed that loss causation is an element of a private right of action for damages under Rule 10b-5.⁸

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1. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

2. *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988).

3. *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

4. *LHLC*, 842 F.2d at 931.

5. *Bastian*, 892 F.2d at 685.

6. 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to its authority under § 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78a-7811 (1988).

7. *Rankow v. First Chicago Corp.*, 870 F.2d 356, 367 (7th Cir. 1989) (“Under the district court’s theory, any intervening change in market conditions not directly caused by the defendant could break the chain of causation and exempt the defendant from liability, a result that would eviscerate Rule 10b-5.”).

8. *See, e.g., Bruschi v. Brown*, 876 F.2d 1526, 1530-31 (11th Cir. 1989); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988); *Kademian v. Ladish Co.*, 792 F.2d 614, 628 (7th Cir. 1986); *Harris v. Union Elec. Co.*, 787 F.2d 355, 366-67 (8th Cir.) (suggesting that both transaction and loss causation can be inferred from the materiality of the nondisclosures), *cert. denied*, 479 U.S. 823 (1986); *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984) (loss causation not an issue when “evil” is in the inducement to invest); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943-44 (2d Cir.) (transaction causation necessary but not sufficient; loss causation must also be shown), *cert. denied*, 469 U.S. 884 (1984); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 n.16 (3d Cir. 1981) (referring to the “ubiquitous requirement that losses be causally related to the defendant’s wrongful acts”), *cert. denied*, 455 U.S. 938 (1982); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549-50 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff’d in part and rev’d in part on other grounds*, 459 U.S. 375 (1983).

The confusion generated by "loss causation" is due in part to its evolving definition. In *Schlick v. Penn-Dixie Cement Corp.*,⁹ the court defined "loss causation" as a "showing" that a defendant's misrepresentations or omissions in connection with a securities transaction "caused the economic harm," but emphasized that such a showing could "rather easily" be made by any proof of injury.¹⁰ In his influential dissent in *Marbury Management, Inc. v. Kohn*,¹¹ Judge Meskill viewed "loss causation" as a species of "proximate cause," and opined that the loss complained of in a securities fraud case must "proceed *directly* and proximately from the violation claimed and not be attributable to some supervening cause."¹² Judge Meskill further defined "loss causation" as the requirement that a "single, direct causal chain run uninterrupted from the alleged violation through a securities transaction to a demonstrable injury."¹³ In *Huddleston v. Herman & Maclean*,¹⁴ the Fifth Circuit echoed Judge Meskill's view that an investor must show that the "untruth" is "in some reasonably direct, or proximate, way responsible for his loss."¹⁵

The notion that a Rule 10b-5 plaintiff must show that the defendant's conduct caused his losses is unremarkable.¹⁶ Yet, *Huddleston's* language goes farther. The court declared: "The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value."¹⁷ Under this formulation of loss causation, the federal courts have begun to require plaintiffs to

9. 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

10. *Id.* at 380.

11. 629 F.2d 705 (2d Cir. 1980).

12. *Id.* at 719 (Meskill, J., dissenting) (citing *Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 51 (1977) (Blackmun, J., concurring) (emphasis in original)).

13. *Id.* at 720 (Meskill, J., dissenting).

14. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

15. *Id.* at 549.

16. *But see* Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469 (1988). Professor Merritt argues that, in appropriate cases, the courts should award 10b-5 plaintiffs damages for "general market losses" when defendants are unable to "carry the burden of proving that their misrepresentations did not touch in any way upon the reasons for the plaintiff's loss." *Id.* at 471. He would also "allow plaintiffs to recover damages even for unrelated market losses if they can show that the misrepresentations induced them to purchase a security that they otherwise would not have chosen at any price." *Id.* Although Professor Merritt's article is an excellent first-step in understanding how the courts have treated the issue of loss causation, it does not address the question of what "loss" is recoverable in a securities fraud action. This Article, by contrast, begins with this fundamental question and only then attempts to resolve the issue of causation.

17. *Huddleston*, 640 F.2d at 549.

prove that the misrepresentation caused *all* of the investment's decline in value before they can recover *any* loss at all.¹⁸ This is remarkable.

In tracking the evolution of these various formulations of loss causation, Part I of this Article shows that this concept is now being used by courts to deny plaintiffs *any* damages when they cannot prove that the defendant's conduct caused *all* of their losses. Part II contends that the arguments advanced in favor of loss causation, based on the statutory scheme underlying the federal securities laws, United States Supreme Court causation decisions, the common law, and public policy, do not support the view that securities fraud plaintiffs must show that the defendant's conduct caused the full decline in the value of their investments before they can recover any damages.

This Article, in Part III, then suggests that loss causation be abandoned in securities fraud actions. To the extent the concept requires plaintiffs to prove the defendant's conduct caused a loss measured at the time of the transaction, it states an obvious damages principle. To the extent it requires, in addition, plaintiffs to prove that the defendant's fraud caused the full posttransaction decline in value of the securities purchased as a condition to any recovery, it states the wrong damages principle.

Loss causation, therefore, should be replaced in securities law jurisprudence with a plain definition of recoverable loss, one that recognizes that the ultimate posttransaction decline in the value of an investment is relevant in a securities fraud action only to the extent that it provides evidence of the recoverable loss, a loss which occurs and is fixed only at the time of the transaction. In Part IV, this Article concludes by showing that this definition easily can be applied in securities fraud cases, and actually reconciles the apparent conflicts among them created by the loss causation confusion.

II. THE EVOLUTION OF LOSS CAUSATION

A. Causation Established by Proof of Actual Reliance

In *List v. Fashion Park, Inc.*,¹⁹ the federal courts first addressed the issue of causation in Rule 10b-5 actions. Recognizing the "confusion" among the parties regarding this issue, the court concluded that the

18. See, e.g., *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 684-85 (7th Cir.), cert. denied, 110 S. Ct. 2590 (1990).

19. 340 F.2d 457 (2d Cir.) (affirming not clearly erroneous district court findings that a shareholder alleging fraud could not prevail because he would have sold even if he had known that an insider had purchased stock and the company resolved to negotiate a merger), cert. denied sub nom. *List v. Lerner*, 382 U.S. 811 (1965).

causal link between the fraud and the harm could be shown by proof that the plaintiff actually relied on the defendant's conduct. The test of reliance is whether "the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss."²⁰ According to the court, it is this reliance requirement that provides the vital function in certifying that "the conduct of the defendant actually caused the plaintiff's injury."²¹

In the wake of *List*, a plaintiff could establish causation in a securities case by proving reliance. When plaintiffs proved that they, in fact, had relied upon material misrepresentations in an offering circular, the Second Circuit confronted for the first time the argument that plaintiffs "must prove not only that the misleading statement caused them to purchase . . . stock but that the statement caused their economic loss by directly affecting the market price of [the] stock."²² The Second Circuit initially rejected that argument, approving a jury instruction that made no distinction between reliance and loss causation.²³ The instruction required the plaintiff to prove that "he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance to them."²⁴ The jury was permitted to find both reliance and loss causation from evidence that the eventual loss was "a reasonably foreseeable result of the misleading statement."²⁵ Because, however, the plaintiffs' only proof on the issue of causation was their actual reliance on the misleading statements, the court effectively collapsed the distinction between loss causation and reliance. The central issue in securities fraud cases became whether the plaintiffs could prove actual reliance.

B. Schlick: Causation Separated From Reliance

It is in that context that the Second Circuit in *Schlick v. Penn-Dixie Cement Corp.*²⁶ first employed the term "loss causation." Although *Schlick* has been called the "most influential opinion employing this terminology,"²⁷ the case actually stresses the relative insignificance of loss causation. Schlick, a minority shareholder of Continental Steel Corporation ("Continental") alleged that Penn-Dixie Cement Corporation ("Penn-Dixie") made material misrepresentations and omissions in

20. *Id.* at 462 (citing RESTATEMENT OF TORTS § 546 (1936)).

21. *Id.*

22. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

23. *Id.* at 1291.

24. *Id.*

25. *Id.* at 1276.

26. 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

27. Merritt, *supra* note 16, at 471 n.5.

its proxy materials in order to reduce the market price of Continental stock and thereafter to effectuate a merger with Continental at an exchange ratio less favorable to Schlick than it would have been absent the misrepresentations. There was no doubt in the case that Schlick had properly alleged loss causation — that the “misrepresentations or omissions caused the economic harm.”²⁸ The court concluded that loss causation is “demonstrated rather easily by proof of some form of economic damage.”²⁹ The “unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed,” according to the Court, “easily” satisfied the requirement of loss causation.³⁰

The difficult issue in the case instead was whether Schlick had properly alleged “transaction causation” — that Penn-Dixie’s proxy fraud caused Schlick, a minority shareholder, to enter into the merger transaction. The court declared that transaction causation typically “requires substantially more” than does loss causation.³¹ Transaction causation was a particularly difficult issue because the transaction was approved by a majority of Continental shareholders. Further, the minority shareholder had not, and could not, allege that he had actually relied on the misrepresentations in question in deciding whether to enter into the merger transaction. Nor did the case involve omissions, the materiality of which could be used to presume reliance.³² Because the plaintiff alleged “market manipulation” and a merger on preferential terms, however, the court concluded that even in this context independent proof of transaction causation was unnecessary.³³ The court thus separated transaction causation from loss causation only to demonstrate that, in that case, proof of transaction causation was as easy as that of loss causation.

C. *After Schlick: Transaction Causation Becomes “Rather Easily” Shown*

Although *Schlick* was written to remove from the plaintiffs the burden of proving transaction causation, it has been read to impose upon plaintiffs the burden of proving loss causation. Since *Schlick*, it is transaction causation that has become “rather easily” proven, and loss causation that has required “substantially more.”³⁴ In *Schlick* itself,

28. *Schlick*, 507 F.2d at 380.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.* at 381.

34. *Id.* at 380. In *Schlick*, of course, it was the reverse: loss causation was “rather easily” established and transaction causation required “substantially more.”

the court suggested that the issue of transaction causation was indistinguishable from "reliance, materiality and the buyer-seller requirement."³⁵ The court further recognized that in Rule 10b-5 cases involving either material nondisclosures or market manipulation, the plaintiff need not show reliance.³⁶ But in a misrepresentation case, the plaintiff must establish transaction causation by proof that "he relied on the misrepresentations in question when he entered into the transaction which caused him harm."³⁷

The evolution of the fraud on the market theory³⁸ and the collapse of the distinction between misrepresentations and omissions, however, have slowly removed from the plaintiff the burden of proving reliance or transaction causation even in misrepresentation cases. Under the fraud on the market theory, courts began to permit plaintiffs³⁹ to establish reliance or transaction causation from mere proof that the defendant made a material misrepresentation "into an impersonal, well-developed market for securities. . . ."⁴⁰ The federal courts also started recognizing that a material misrepresentation is nothing other than the failure to disclose a material fact that would make the representation not misleading.⁴¹ One court defined a material misrepresentation as a "half-truth"; it is deceptive because of what it omits.⁴² When the distinction between misrepresentation cases and omission cases is blurred, plaintiffs can establish reliance or transaction causation from materiality in both, indeed all, types of securities fraud actions.⁴³

35. *Id.* at 380 n.11.

36. *Id.* at 381.

37. *Id.* at 380.

38. As "[s]uccinctly put" by the Supreme Court, the "fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations." *Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

39. The 1975 case of *Blackie v. Barrack*, 524 F.2d 891, 905-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), is the first reported appellate decision embracing the theory. The Second Circuit adopted the theory in *Panzirer v. Wolf*, 663 F.2d 365, 367-68 (2d Cir. 1981), *cert. denied*, 458 U.S. 1107 (1982).

40. *See Basic*, 485 U.S. at 247.

41. *See, e.g., Competitive Assocs., Inc. v. Laventhol Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975).

42. *Flamm v. Eberstadt*, 814 F.2d 1169, 1173 (7th Cir.), *cert. denied*, 484 U.S. 853 (1987).

43. *See, e.g., Laventhol*, 516 F.2d at 814.

D. Huddleston: *Loss Causation Requires Substantially More*

When transaction causation or reliance became “rather easily” established from proof of the materiality of a misrepresentation or omission, courts grew concerned once again that plaintiffs might be able to recover damages without any showing of an actual link between their losses and the defendant’s conduct.⁴⁴ In *Huddleston v. Herman & MacLean*,⁴⁵ this concern led the court to embrace loss causation.⁴⁶ After characterizing reliance as a subjective inquiry into whether the plaintiff actually based his investment decision on a misrepresentation or omission and characterizing materiality as an objective inquiry into whether the plaintiff reasonably based his investment decision on the misrepresentation or omission, the court concluded that “causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a *proximate* cause of the loss?”⁴⁷ The court further stated that the Rule 10b-5 causation requirement is met “only if the misrepresentation touches upon the reasons for the investment’s decline in value.”⁴⁸

44. See, e.g., *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir.) (Meskill, J., dissenting) (citing *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969) (“causation must be proved else defendants could be held liable to all the world”), *cert. denied*, 397 U.S. 913 (1970)), *cert. denied*, 449 U.S. 1011 (1980).

45. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *aff’d in part and rev’d in part*, 459 U.S. 375 (1983).

46. *Huddleston* has been called the “leading case” in adopting loss causation. Merritt, *supra* note 16, at 478. Indeed, while *Schlick* first expressly distinguished loss causation from transaction causation, *Huddleston* first interposed loss causation as a significant evidentiary issue.

47. *Huddleston*, 640 F.2d at 549 (citing *Herpich v. Wallace*, 430 F.2d 792, 810 (5th Cir. 1970) (emphasis in original)).

48. *Id.* The phrase “touches upon” is taken from the United States Supreme Court’s opinion in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). In that case, however, Justice Douglas used the term “touching” as a metaphor to describe § 10(b)’s statutory requirement that the fraud be “in connection with” the purchase or sale of securities. *Id.* at 12-13. According to the Court, when the plaintiff establishes that he has “suffered an injury as a result of deceptive practices touching [his] sale of securities,” he has established that the fraud was in connection with his sale of securities. *Id.* The issue in *Bankers Life* was not whether the plaintiff-corporation had suffered losses as a result of the defendants’ fraudulent practices. Indeed, there was no dispute in that case that the defendants’ scheme, under which the corporation received no consideration in return for its sale of \$5 million worth of its securities, caused that corporation’s pecuniary loss. *Id.* at 9-10. Rather, the issue addressed by the Court was whether defendants’ alleged scheme was “in connection with” a securities transaction with the plaintiff, as opposed to in connection with “internal corporate mismanagement.” *Id.* at 12. The Court reached its result despite its agreement that “Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.” *Id.* When the conduct at least touches upon a securities transaction, the

The *Huddleston* decision itself however does not present an insuperable barrier to recovery for securities fraud. Plaintiffs must establish reliance, materiality, and loss causation, but the court allows reliance to be presumed from materiality.⁴⁹ Moreover, in its discussion of the damages available to the plaintiffs on remand, the court made clear that they could recover by showing that the defendant's misrepresentation or omission created a difference between the transaction price and the "real" value of the security at the time of the transaction.⁵⁰ The court assumed that the challenged misrepresentations regarding the cost of completing a Speedway were not the cause of the Speedway's bankruptcy and the "investment's decline in value." Nonetheless, the court remanded for a new trial, allowing plaintiffs to recover to the extent that they could show that the misrepresentation created a difference between the price they paid for their interests in the Speedway and the true value of those interests at the time of their transactions.⁵¹ In application, the court allows plaintiffs to recover even when the misrepresentation does not touch upon the reasons for the investment's ultimate decline in value, so long as the misrepresentation creates a disparity between the purchase price and the true value of the securities at the time of the transaction.

E. After Huddleston: Loss Causation Used to Deny All Recovery

Courts have employed the definition of loss causation suggested by *Huddleston* as a tool for denying all recovery when the plaintiff could not show that the fraud "touche[d] upon the reasons for the investment's decline in value."⁵² The Seventh Circuit's *Bastian v. Petren Resources Corp.*⁵³ opinion represents the heyday of this approach. There, plaintiffs who purchased oil and gas limited partnership interests brought a Rule 10b-5 action against the general partners and their attorneys. Plaintiffs claimed that if the private placement memorandum had disclosed that the general partners previously had been sued and had defaulted in loan

Court suggests, such conduct falls within the ambit of § 10(b) "whatever might be available as a remedy under state law." *Id.* Whereas the *Bankers Life* opinion employs the touching metaphor to describe the requisite connection between conduct and a securities transaction, the *Huddleston* opinion uses that metaphor to suggest a new requirement that conduct cause an investment's decline.

49. *Huddleston*, 640 F.2d at 547-48.

50. *Id.* at 556.

51. *Id.*

52. See, e.g., *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988) (quoting *Huddleston*, 640 F.2d at 549); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

53. 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

payments in connection with other oil and gas limited partnerships,⁵⁴ they would not have invested. Noting that the plaintiffs had failed to allege that these omissions were "causally linked to the loss in value of plaintiffs' investments,"⁵⁵ the district court dismissed the complaint.⁵⁶

In affirming the dismissal, the Seventh Circuit precisely delineated the flaw in plaintiffs' complaint: "They have alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction's turning out to be a losing one."⁵⁷ The court suggested, in the language of *Huddleston*, that the plaintiffs must show that the omissions caused the "investment's decline in value."⁵⁸ Unlike *Huddleston*, however, which remanded the action for trial on the issue of whether the defendants' conduct created a difference between the price and the value of the securities at the time of the transaction, the Seventh Circuit concluded that the oil and gas investors could recover no damages whatsoever. By this view of loss causation, even if plaintiffs can prove that the defendant's fraud caused them to pay too much for securities at the time of the transaction, they may nonetheless not recover any damages unless they can also prove that the fraud caused the posttransaction decline in the value of their investments. This can be an insuperable barrier to recovery.

III. THE ARGUMENTS SUPPORTING LOSS CAUSATION

In concluding that Rule 10b-5 plaintiffs must prove that the defendant's conduct caused their investment's decline in value, courts and commentators have relied upon: (1) analogies to the overall scheme of the federal securities laws; (2) inferences from Supreme Court causation decisions; (3) the model of the common law of torts, and (4) the threat of unlimited liability.⁵⁹ This section addresses each of these arguments, concluding that none of them supports a requirement that plaintiffs prove that defendant's conduct caused their investments to decline in value.

54. See *Bastian v. Petren Resources Corp.*, 681 F. Supp. 530, 532 (N.D. Ill. 1988), *aff'd*, 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

55. *Bastian*, 681 F. Supp. at 533.

56. *Id.* at 535.

57. *Bastian*, 892 F.2d at 684.

58. *Huddleston*, 640 F.2d at 549.

59. See, e.g., *Marbury Management v. Kohn, Inc.*, 629 F.2d 705, 716-23 (2d Cir. 1980) (Meskill, J., dissenting) (raising each of these arguments in a strong dissent); Merritt, *supra* note 16, at 484-506 (arguing that neither the federal regulatory scheme nor the common law rejects recovery of "gross" losses even when no proximate cause shown).

A. Analogies To The Regulatory Scheme

The federal courts have inferred from section 10(b) the congressional intent to create a private right of action for damages.⁶⁰ Because the private right of action is the product of the "federal common law,"⁶¹ so too are its elements. In developing the elements of the inferred 10b-5 private right of action, the federal courts have drawn guidance from the elements of the private rights of action that Congress has expressly created. None of the express rights of action, however, supports an inference that Congress would have intended to require plaintiffs to prove as a condition to any recovery under Rule 10b-5 that the decline in value of their investment was caused by the defendant's fraud.

The express antifraud rights of action in the 1933 Act⁶² clearly do not require the plaintiffs to prove that the defendant's conduct caused their investments to decline in value. Section 11 of the 1933 Act expressly allows acquirers of securities offered pursuant to a registration statement containing a material misstatement or omission to obtain damages from the issuer, its officers, directors, and professionals.⁶³ Section 11(e) contains an elaborate damage formula that allows plaintiffs to recover the difference between the offering price and either the "value" of the security at the time of the suit or the price received if sold before suit.⁶⁴ Section 11, however, contains a proviso that states:

*Provided, [t]hat if the defendant proves that any portion of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.*⁶⁵

This proviso has been called a "proximate cause limit," which is "analogous to the loss causation concept"⁶⁶

The proviso, however, does not suggest that even in section 11 cases the plaintiff is required to prove that the defendant's conduct caused the investment's decline in value. First, and most obviously, the proviso shifts to the defendant the burden of proving that the plaintiff's losses

60. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

61. *Bastian*, 892 F.2d at 685.

62. 15 U.S.C. §§ 77a-77aa (1988).

63. *Id.* § 77k.

64. *Id.* § 77k(e).

65. *Id.* (emphasis in original).

66. Merritt, *supra* note 16, at 488.

were not caused by the defendant's material misstatements or omissions.⁶⁷ To the extent that Congress has recognized the concept of loss causation, it has placed the burden on the defendant to prove the absence of causation.

Second, the concept of loss causation recognized in section 11(e) allows defendants to limit their exposure to the amount by which their material misstatement or omission has altered the purchase price of the securities. Even if the proviso placed on the plaintiff the burden of proving that the decline in the value of the security resulted from the defendant's misrepresentation, the plaintiff could recover some amount of damages without proving that the defendant's conduct caused the full decline in the value of the securities.

Indeed when Congress has placed upon the plaintiffs the burden of proving causation, it has indicated that the burden may be discharged by proof that the defendant's conduct created a disparity between the price and the value of the securities at the time of the transaction. Section 9(e)⁶⁸ of the Securities Exchange Act of 1934 grants an express right of action against willful participants in the manipulation of securities prices for "damages sustained as a result of any such act or transaction" which affects the price at which the plaintiff purchases or sells a security.⁶⁹ The United States Supreme Court has suggested that the requisite link between conduct and loss under this section can be established by proof that the defendant's pretransaction conduct created a difference between the price and the value of the securities at the time of the transaction. In *Piper v. Chris-Craft Indus., Inc.*,⁷⁰ the Court concluded that in drafting this language in section 9(e), Congress "focused . . . upon the amount actually paid by an investor for stock that had been the subject of manipulative activity."⁷¹ In that case, Chris-Craft, unsuccessful in its efforts to acquire control of Piper, filed suit against the target's management, its investment advisor, and its successor, Bangor Punta, alleging violations of section 14(e)⁷² of the Exchange Act and SEC Rule 10b-6.⁷³ The Court relied upon section 9 in reaching its holding that Chris-Craft had no standing to sue under Rule 10b-6 absent allegations that the price it paid for the target's shares was altered by the defendants'

67. Professor Merritt quickly points this out and astutely cites a host of cases in which the courts have placed on the defendant the burden of proving such causation. See Merritt, *supra* note 16, at 488.

68. 15 U.S.C. § 78i(e) (1988).

69. *Id.*

70. 430 U.S. 1 (1977).

71. *Id.* at 46.

72. 15 U.S.C. § 78n(e).

73. 17 C.F.R. § 240.10b-6 (1990).

conduct.⁷⁴ Because Chris-Craft sought only “compensation for its lost opportunity to control Piper,”⁷⁵ the Court concluded that it lacked standing to seek damages. Had Chris-Craft alleged that the defendants’ conduct altered the price they paid for the target’s shares, it presumably would have had standing to recover damages.

As Justice Blackmun’s concurrence makes clear, the Court’s analysis of the standing issue could well apply to the causation issue. In that concurrence, Justice Blackmun finds that Chris-Craft has standing, but concludes that it nonetheless should not be able to recover damages because its allegations fail to establish sufficient causation. The element of causation was missing because Chris-Craft had not even “suggested” that the “price which it paid for Piper shares was influenced” by defendants’ manipulative conduct.⁷⁶ Justice Blackman made clear, however, that if Chris-Craft had sought damages from its overpayment for Piper shares, rather than damages for its lost opportunity to control Piper, proof that the defendants’ conduct “influenced” the purchase price of Piper shares would have been sufficient to establish causation.⁷⁷ Federal courts interpreting section 9(e) since *Piper* have agreed that the link between conduct and loss is supplied by proof that the defendant’s conduct created a difference between the price and the value of the securities traded, at the time of the transaction.⁷⁸

Similarly, section 18⁷⁹ of the 1934 Act, which like section 9(e) expressly requires some showing of causation, does not require plaintiffs to prove that the defendant’s conduct — materially misleading statements in reports filed pursuant to the 1934 Act⁸⁰ — caused the posttransaction decline in their investment’s value. That section allows persons who buy or sell securities in “reliance” upon misleading statements and at a price “affected by” the misleading statement to recover “damages caused by such reliance.”⁸¹ Arguably, this provision requires plaintiffs to prove (1)

74. The Court justified its reliance on § 9 because of its close relationship to Rule 10b-6 and because the SEC, in an amicus brief, had suggested that its authority to promulgate Rule 10b-6 derived from § 9 as well as from § 10. See generally *Piper*, 430 U.S. 1.

75. *Id.* at 46.

76. *Id.* at 52-53. The Court finds this point, which is referred to by the majority, “conclusive” on the issue of causation. *Id.*

77. *Id.* at 53.

78. See, e.g., *Crane v. American Standard, Inc.*, 603 F.2d 244, 253 (2d Cir. 1979) (section 9 requires more than a “generalized” showing of causation; causation shown from proof that conduct altered securities transaction price); *Shull v. Dain, Kalman & Quarl, Inc.*, 561 F.2d 152 (8th Cir. 1977), cert. denied, 434 U.S. 1086 (1978).

79. 15 U.S.C. § 78r (1988).

80. *Id.*

81. *Id.* § 78r(a).

reliance; (2) that the misleading statement affected the transaction price (transaction causation); and (3) that the defendant's conduct caused damages (loss causation). That the defendant's misleading statements caused the plaintiff's loss, however, can be proved from evidence that the plaintiff's reliance on the misleading statements induced him to trade at a price "affected" by the statements. Congress allows the recovery of "damages caused by such reliance," indicating that the loss recoverable under section 18 is the amount by which the transaction price was "affected by" the misleading statement relied upon. In a case in which reliance is established (or presumed), therefore, Congress allows the recovery of "damages" when the plaintiff shows that the defendant's misleading statement altered the plaintiff's transaction price. In both section 18 and section 9, Congress has indicated that the "loss" recoverable for misleading public statements and conduct that otherwise manipulates the price of a securities transaction, is the amount by which the defendant's conduct has affected the plaintiff's transaction price. In that context, the issue of causation becomes self-evident: plaintiffs must prove that the defendant's conduct altered the transaction price. There is no support in either section 9 or section 10 for the position that Congress intended damages to be recoverable only if plaintiffs could prove that the defendant's conduct caused the posttransaction decline in the value of their investments.

A fortiori, the remaining express rights of action, none of which suggest a causation element, do not support any requirement that plaintiffs prove defendant's conduct caused a posttransaction decline in their investment's value. Section 12(2) of the 1933 Act,⁸² which creates a private right of action against any person who offers or sells a security through material misstatements or omissions,⁸³ allows successful plaintiffs to "recover the consideration paid for such a security with interest thereon less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."⁸⁴ This section is thought to create a "broad rescissionary measure of damages,"⁸⁵ and it allows defrauded buyers to recover damages without showing causation.⁸⁶ Indeed, the Supreme Court has observed that in section 12(2) "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud."⁸⁷ According to the Court, the deterrent

82. *Id.* § 771.

83. *Id.*

84. *Id.*

85. Merritt, *supra* note 16, at 491.

86. *See, e.g.*, LOSS, FUNDAMENTALS OF SECURITIES REGULATION 890 (1988).

87. *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986).

purposes of that section would be "ill-served by a too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss.'"⁸⁸

Courts and scholars reason from the language of section 12(2) and those interpretations of it, that Congress did not intend to require plaintiffs to prove that the defendant's material misstatements or omissions caused their investments to decline in value.⁸⁹ That much is clear. What is less clear is whether Congress intended to require section 12(2) plaintiffs to prove that the defendant's misstatements or omissions caused their recoverable loss. The loss recoverable under section 12(2) is limited to the purchase price of the security.⁹⁰ Therefore, although the risk of posttransaction decline may, as a consequence, fall upon the defendant, that decline itself is simply irrelevant to section 12(2) recovery. Loss is measured only at the time of the transaction. Even in section 12(2), Congress consistently rendered posttransaction stock movements irrelevant to the issue of loss.

Moreover, although a successful 12(2) plaintiff can recover his or her full purchase price, that purchase price typically in a section 12(2) case reflects the materiality of the defendant's misrepresentations. Congress has presumed that in a typical section 12(2) case in which a seller of securities necessarily "solicits"⁹¹ the sale by making material misstatements or omissions to the buyer, those misstatements or omissions will be so material as to induce the sale itself — not just the sale at a higher price. Accordingly, in section 12(2) Congress intended to limit the issue of causation to pretransaction conduct that creates a difference between the transaction price and the value of the securities at the time of the transaction.

Even in its express disgorgement remedies, Congress has refused to burden plaintiffs with showing that the defendant's conduct caused a fluctuation in the value of their investments. Section 16(b) of the 1934 Act allows a corporation to recover profits realized from the short-swing trading of its stock by its officers, directors, and ten-percent shareholders.⁹² Similarly, newly-enacted Section 20A of the 1934 Act, allows

88. *Id.* at 664 (citation omitted).

89. *See, e.g.,* Merritt, *supra* note 16, at 491-92.

90. The statute allows recovery of the "consideration paid" (or purchase price) plus interest, and less any income received. Interest is the equivalent of prejudgment interest, and the deduction for income received, of course, merely makes a wash of income gained. 15 U.S.C. § 771(2) (1988).

91. In *Pinter v. Dahl*, 486 U.S. 622 (1988), the Supreme Court defined a "seller" under the identical language of § 12(1) of the 1934 Act as someone who "successfully solicits" the sale of securities to benefit himself or the title holder.

92. 15 U.S.C. § 78p(b) (1988).

persons who trade "contemporaneously" with one in possession of material non-public information to recover from the insider "the profit gained or loss avoided" in the transaction.⁹³ Both disgorgement remedies limit recovery to the profit realized as a result of the transactions.⁹⁴ In order to determine the profit realized from transactions made unlawful under section 16(b) or section 20A, the factfinder must, of course, analyze the performance of the security after the transaction has taken place. In both cases, the analysis requires comparing the defendant's initial purchase or sales with subsequent resales or repurchases. Yet, the objective of the analysis is always to determine whether and to what extent the defendant's conduct has created a difference between the price and the value of the securities at the time of the unlawful transaction.

The director, for example, who buys his corporation's stock at \$100 per share without disclosing material, nonpublic merger information and sells the stock at \$150 per share when, three months later, the merger is consummated, must under both section 16(b) and section 20A disgorge his profits. The defendant's profit results from two transactions, but only the first transaction was entered with material, nonpublic information. The profit realized from the second transaction is only *evidence* of the illegal profits from the initial transaction. Moreover, the profit realized from the second transaction is evidence of the degree to which the initial transaction price diverged from the value of the securities at the time of the initial transaction. The initial transaction price was \$100 per share, but that price presumably would have been much higher if the defendant had disclosed the material, nonpublic information regarding the imminent merger.

The rise in price after disclosure is strong evidence of the effect that the defendant's omission had on the transaction price of the first transaction. The rise in market price, of course, is also the defendant's profit. Accordingly, the defendant's profit measures the disparity that the defendant's conduct has created between the price and the value of the securities traded. Not only do Congress's disgorgement remedies relieve plaintiffs of the burden of proving that the defendant's conduct caused the posttransaction decline in the value of their investment, but they reduce posttransaction price movements to evidence of the effect that the defendant's conduct had on the price of the transaction itself.

Finally, some courts and commentators have relied upon section 28 of the 1934 Act as support for requiring plaintiffs to prove that the

93. *Id.* §§ 78t-1(a),(b).

94. Section 16(b) allows recovery of "any profit realized by him *from* any purchase and sale, or any sale and purchase" of a security within six months. *Id.* § 78p. Section 20A allows recovery of profit gained or loss avoided "in the transaction or transactions that are the subject of the violation." *Id.* § 78t-1(b).

defendant's conduct caused their investments to decline in value.⁹⁵ That section limits recovery under the 1934 Act provisions to "actual damages on account of the act complained of."⁹⁶ Professor Merritt demonstrates persuasively that the context, structure, policies, and judicial interpretations of this section do not preclude recovery of damages in excess of the "net economic harm suffered by the plaintiff."⁹⁷ Professor Merritt goes so far as to argue that section 28(a) allows plaintiffs to recover the full decline in the value of their investment ("gross economic loss") even if they are unable to show that the decline was caused by the acts challenged.⁹⁸ Regardless of whether that assertion is correct, section 28(a) certainly does not require plaintiffs to prove that the defendant's conduct caused the posttransaction decline in value of their securities as a condition to their recovering the difference between their transaction price and the value of their securities at the time of the transaction.

B. Supreme Court Declarations on Causation in Securities Cases

When the Supreme Court has addressed the issue of causation under the securities laws, it has done so primarily in the context of implied rather than express rights of action.⁹⁹ None of its opinions developing a federal common law of causation supports the position that plaintiffs must prove that the defendant's conduct caused their investments to decline in value.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,¹⁰⁰ the Court concluded that because the plaintiff "suffered an injury as a result of deceptive practices touching its sale of securities as an investor," it had standing to pursue a section 10(b) action.¹⁰¹ This lan-

95. See, e.g., *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 719 (2d Cir. 1980) (Meskill, J., dissenting); Merritt, *supra* note 16, at 485 n.76 (citing cases and commentary).

96. 15 U.S.C. § 78bb(a) (1988).

97. Merritt, *supra* note 16, at 485-87 (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986)).

98. Merritt, *supra* note 16, at 476-77.

99. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (causation in the context of Rule 10b-5 materiality and fraud on the market concepts); *Randall v. Loftsgaarden*, 478 U.S. 647 (1986) (discussing causation in the context of § 12(2) and Rule 10b-5); *Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1 (1977) (Blackmun, J., concurring) (addressing causation under the § 14(e) implied right of action for tender offer fraud); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (developing standards of causation under Rule 10b-5); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (addressing causation in the context of § 10(b)'s "in connection with" requirement); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (developing standards of causation under § 14(a)'s implied right of action for proxy fraud).

100. 404 U.S. 6 (1977).

101. *Id.* at 12-13.

guage suggests that standing hinges on the ability to allege injury caused by deceptive practices. But, in the context of the facts of *Bankers Life*, this language cannot be read to require plaintiffs to allege and prove that the defendant's fraud caused a posttransaction decline in the value of securities. First, the issue confronted by the Court was not whether the fraud caused the plaintiff-corporation's losses. Rather, the issue was whether the fraud was "in connection with" the purchase or sale of securities. In the context of defining that requirement, the Court declared that when the fraud involves a securities transaction, rather than just internal corporate management issues, the fraud is within the ambit of the federal securities laws.¹⁰² The Court's focus, therefore, was not upon the relationship between the defendant's conduct and the plaintiff's losses.

Second, even if the Court's reasoning is strong enough to reach the issue of causation, that reasoning suggests that plaintiffs need only show a causal link between the defendant's conduct and losses suffered at the time of the transaction. In *Bankers Life*, the plaintiff corporation alleged that it was injured as a result of the defendant director's failure to disclose the material fact that it would effectively receive no consideration in return for its sale of \$5,000,000 of United States Treasury Bonds.¹⁰³ The subsequent performance of the Bonds was simply irrelevant to the issue of whether the corporation had alleged a sufficient nexus between the defendant's conduct and the difference between the value of the securities sold and the price received.

Similarly, in *Affiliated Ute Citizens v. United States*,¹⁰⁴ the Court suggested that the element of causation in a section 10(b) action may be established by proof of conduct that creates a difference between the transaction price and the value of a security at the time of the transaction. The Court concluded that in section 10(b) cases involving primarily a duty to disclose, the materiality of the nondisclosure establishes the "requisite causation in fact."¹⁰⁵ The Court's characterization of "causation in fact" as "requisite" indicates its view that some degree of causation is a necessary element of a section 10(b) claim. Indeed, Justice Blackmun later declared that *Affiliated Ute* "did not abolish the requirement of causation" even in "failure-to-disclose cases."¹⁰⁶

Yet, neither did *Affiliated Ute* suggest that in proving causation, plaintiffs must establish that the defendant's conduct caused a post-

102. *Id.*

103. *Id.* at 9 ("[T]he seller was duped into believing that it, the seller, would receive the proceeds [of the sale].").

104. 406 U.S. 128 (1972).

105. *Id.* at 153-54.

106. *Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 51 (1977) (Blackmun, J., concurring).

transaction decline in the value of their investments. In the case itself, a bank's transfer agents purchased securities from mixed-blood Ute Indians without disclosing to them the material fact that these securities could be resold on an active non-Indian market for substantially greater amounts.¹⁰⁷ In order to recover for the fraud, the plaintiffs need not show that the defendant's omissions caused the posttransaction increase in the value of the securities. Instead, the Court clearly stated that plaintiffs may recover "the difference" between their actual transaction price and what their transaction price would have been absent the fraudulent conduct.¹⁰⁸

Recoverable loss is measured only at the time of the transaction. Accordingly, the issue of causation is necessarily limited to the defendant's effect on the transaction price. When plaintiffs show that the defendant's conduct created a difference between the transaction price and the value of the securities at the time of the transaction, they have established that the defendant's conduct caused their losses. When, as in *Affiliated Ute*, the defendant's conduct is the failure to disclose facts, plaintiffs may prove that such conduct caused their losses by showing that the concealed facts are material.

Since *Affiliated Ute*, the Supreme Court has made clear that plaintiffs may establish that their recoverable losses were caused by the defendant's conduct by proving that the defendant's misrepresentations or omissions were material. According to Justice Blackmun, the materiality of a nondisclosure provides the "causal link between the omission of material information and the shareholder's act of purchasing or selling stock."¹⁰⁹ When, as in section 10(b) actions, the act of buying or selling stock reflects the loss itself, the materiality of the nondisclosure provides the "causal link" between the defendant's unlawful conduct and that loss.

The Supreme Court's reasoning in *Randall v. Loftsgaarden*¹¹⁰ also suggests the irrelevance of posttransaction fluctuations in the value of an investment to the issue of causation in a securities fraud action. In *Randall*, the Court ruled that tax benefits received by an investor in a tax shelter venture may not be offset against rescissory damages awarded in cases brought under section 12(2).¹¹¹ In reaching its holding, the Court agreed with arguments presented by amici¹¹² that tax benefits, because they accrue only in conjunction with taxes owed and other income

107. *Affiliated Ute Citizens*, 406 U.S. at 151-52.

108. *Id.* at 155.

109. *Piper*, 430 U.S. at 51 (Blackmun, J., concurring).

110. 478 U.S. 647 (1986).

111. *Id.* at 662.

112. The United States and the Securities Exchange Commission both filed amicus briefs in the case.

generated by the investor, would not have been a benefit derived from the securities without the intervention of an independent transaction by the investor.¹¹³ Tax benefits, accordingly, are not part of the fair value of all that the investor receives. The Court also found that tax benefits are not part of the fair value of the consideration paid by the investors: “[T]he consideration given by petitioners in exchange for their partnership interests took the form of money, not tax deductions, and the fact that [investors] received tax deductions from which they were able to derive tax benefits, therefore, cannot constitute a return of that consideration.”¹¹⁴ According to the Court’s logic, tax benefits would have no impact upon the measure of loss, a measure that must be made at the time of the transactions. The difference between the fair value of all that the plaintiffs received and the fair value of their consideration at the time of the transaction would not reflect posttransaction tax benefits at all.¹¹⁵

113. *Randall*, 478 U.S. at 662.

114. *Id.* at 660.

115. The Court’s rationale for not including tax benefits in the calculation of damages, thus, is not based on their theoretical incompatibility with § 12(2)’s rescissory measure of damages. Indeed, pure rescission, which requires both parties to return to their pretransaction condition, may require an offset. Rather, the Court’s holding is based upon the premise that tax benefits have no place in determining the fair value of securities or consideration. *See id.* at 663-64 (allowing tax benefit may insulate those committing fraud). Because the calculation of the difference between the fair value of securities and the fair value of consideration, exclusive of tax benefits, is equivalent to a quantification of the materiality of the misstatement or omission, *id.* at 664, the Court’s judgment that tax benefits have no place in that calculation is a judgment that such benefits are not material to the purchase or sale of securities.

The Court’s assertion that its position did not defy economic reality further supports this interpretation of its decision. *See id.* at 665-66 (tax benefit not separate asset acquired by purchase of share of limited partnership). The economic reality at the time the case was decided was that a primary motive for investing in limited partnerships was to realize tax benefits. *Id.* The Court even noted that some lower courts had held that investors may sue for securities fraud when the defendant misrepresented the tax benefits of the investment, finding that the existence of those benefits was material. *Id.* at 665 (citing *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982)).

The Court, however, rejected those cases and the so-called economic reality approach. First, the Court found no evidence that Congress considered tax benefits to be material when it drafted § 12(2). *Id.* Second, the Court rejected the notion that tax benefits are a separate asset that can be valued apart from the partnership interest. *Id.* Third, and most significantly, the Court recognized that the tax benefits are not liquid; they cannot be freely transferred from one person to another apart from the partnership interest. *Id.* at 665-66. It would be impossible, therefore, to attach a reasonable or objective market value to a tax benefit because each investor’s benefits would be different in each taxable year. Because it is impossible to affix to tax benefits a distinct fair value, it is also

Finally, in *Basic Inc. v. Levinson*,¹¹⁶ the Supreme Court clearly stated that plaintiffs may recover under section 10(b) without proving that the

impossible to assess the significance of the benefits to the "reasonable" investor.

In other words, the materiality of statements or omissions about tax benefits is, as the Court suggested, impossible to assess in any given case. *Id.* at 664. That problem, however, could have been solved by finding that tax benefits are either always or never material. The issue the Court really had to decide, therefore, was whether tax benefits are always or never material; it could not have adopted a case-by-case approach. The Court decided that they were never material because not only is the materiality of tax benefits difficult to assess on a case-by-case basis, but the amount of damages, which would have to be calculated only if benefits were always material, is also difficult to compute. The Court, in fact, recognized the difficulty of calculating damages based upon the materiality of tax benefits when it recited the "formidable difficulties in predicting the ultimate treatment of the investor's claimed tax benefits . . ." *Id.* at 665. The Court in *Randall*, therefore, authorized the lower courts to ignore tax benefits in their calculation of damages under § 12(2) not because it is consistent with a rescissionary measure of damages, but because tax benefits are immaterial as a matter of law.

In his concurrence, Justice Blackmun questioned whether tax benefits are, as the majority suggested, always immaterial. He agreed with the majority that tax benefits should not be considered in calculating "income" or "consideration" under § 12(2), or when rescission is the proper remedy under § 10(b). *Id.* at 667-68 (Blackmun, J., concurring). Nor did he question that the disparity between fair value received and relinquished is typically the proper measure of § 10(b) damages. *Id.* at 668 (Blackmun, J., concurring). Justice Blackmun concurred that the materiality of the misrepresentation is tantamount to the portion of the purchase price attributable to an asset never received. *Id.* at 669 (Blackmun, J., concurring).

Justice Blackmun observed, however, that in calculating the disparity between purchase price and fair value of what was received, all of the elements that go into the price of the tax shelter should be taken into account, including the value of the tax write-offs. *Id.* at 668 (Blackmun, J., concurring). Unlike the majority, Justice Blackmun believes that the "level of potential tax benefits" can be separately valued and quantified as a portion of the fair value which the securities buyer receives. *Id.* at 669 (Blackmun, J., concurring). An investor can be *materially* misled about the value of those tax benefits, as well as about the value of the underlying asset. In other words, Justice Blackmun found that tax benefits can be material in some cases. He wrote separately to observe that because tax benefits can be material in some cases, they deserve some consideration in the calculation of the fair value disparity.

Although the majority concluded that tax benefits are never material and the concurrence observed that they are sometimes material, the dissent perceived that they are always material in tax shelter investments. In his dissent, Justice Brennan concluded that the "inure" which purchasers receive from their investments should, under both § 12(2) and Rule 10b-5, be considered in calculating the disparity between fair value paid and fair value received. *Id.* at 672 (Brennan, J., dissenting). In support of his position, Justice Brennan asserted that economic reality dictates that "a major portion of what the investor bargains for and purchases in a tax shelter is the tax benefit." *Id.* According to Justice Brennan, because tax benefits are a "major" portion of the fair "value" that the investor receives, they are material and, therefore, should be considered in calculating the difference between the fair value of what the investor receives and the fair value of what the investor pays. *Id.* at 674 (Brennan, J., dissenting).

116. 485 U.S. 224 (1988).

defendant's conduct caused the posttransaction decline in the value of their investment. Justice Blackmun, writing for the Court,¹¹⁷ indicated that in a Rule 10b-5 case, the "nexus" between the defendant's conduct and the plaintiff's "injury" is a "necessary" one.¹¹⁸ But it is reliance that provides the "requisite causal connection between a defendant's misrepresentation and the plaintiff's injury."¹¹⁹ The "causal connection" or the "necessary nexus" between the plaintiff's "injury" and the defendant's conduct can be established by proof of the materiality of the omissions in nondisclosure cases or the materiality of either misstatements or omissions in a fraud on the market case.¹²⁰

In discussing how the presumption of reliance and causation may be rebutted, the Court ignores the posttransaction movements in the value of the security. The relevant causal "link" is that between the defendant's misrepresentation and "either the price received (or paid) by the plaintiff."¹²¹ The "causal connection" may be "broken" only if the defendant shows that the transaction price was unaltered by the misrepresentation.¹²² In other words, the causation that counts in Rule 10b-5 cases is the nexus between the defendant's conduct and the transaction price. When plaintiffs prove that omissions created a difference between that transaction price and the true value of the securities at the time of the transaction, they have established that the defendant's conduct caused their recoverable losses.¹²³

117. Because Justices Rehnquist, Scalia and Kennedy did not participate in the case, and Justices White and O'Connor dissented from this portion of the Court's opinion, Justice Blackmun writes for only four Justices.

118. *Basic*, 485 U.S. at 244.

119. *Id.* at 243.

120. The Court cites *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), for the former proposition and holds in *Basic* itself that material nondisclosures or misstatements on an active market create a rebuttable presumption of reliance. *Basic*, 485 U.S. at 244-45.

121. *Id.* at 248.

122. *Id.* at 248-49.

123. Footnote 28 in *Basic* suggests that the market price of *Basic* stock may have reflected the alleged nondisclosures "quickly" and then emphasizes that the Court's "decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind." *Id.* at 248 n.28. Despite its caution, the Court's footnote and its opinion do suggest the loss that is recoverable under § 10(b). *Id.* Its footnote would contain a nonsequitur if there were no connection between the hint that the market price may have quickly reflected the alleged nondisclosures and the proper measure of damages in the case. Indeed, when the plaintiff's transaction price fully reflects the alleged nondisclosure, no damages may be recovered. Conversely, when the alleged nondisclosure creates a disparity between the transaction price and the value of the securities, then damages may be recovered. Recoverable loss, therefore, is the difference that the defendant's conduct creates between the price and the value of securities traded. Because that loss is

The Supreme Court's treatment of the issue of causation in proxy and tender offer fraud cases further demonstrates the relative insignificance of posttransaction events. In *Mills v. Electric Auto-Lite Co.*, the Court concluded that the "causal relationship" between misrepresentations in proxy solicitation materials and the plaintiff's "injury" can be established by proof that the misrepresentations were material and that the "solicitation" was an "essential link in the accomplishment of a merger transaction."¹²⁴ The Court left open the question of whether causation could be shown between material misrepresentations in proxy materials and the consummation of a merger when management controls a sufficient number of shares to approve the transaction without the minority's votes.¹²⁵ As *Mills* suggests, the answer to this unresolved question of causation and to the question of causation under section 14(a) generally cannot be reached without reference to the recovery sought. Stating that "[m]onetary relief" will be a "possibility" to redress section 14(a) violations, the Court observed that when the loss sought is the difference between the actual merger price and the merger price absent the misrepresentation, that loss is obtainable by a showing that the misrepresentation was material.¹²⁶ When plaintiffs cannot establish "direct injury" as an ultimate consequence of the merger, they may nonetheless recover when the defendant's conduct adversely alters the terms of the merger accepted by the shareholders.¹²⁷ In either case, loss is measured at the time of the merger transaction, and causation is established when the plaintiffs prove that the defendant's conduct altered the terms of that transaction.

The Court's analysis of causation in section 14(e) tender offer fraud cases is consistent. In *Piper v. Chris-Craft Industries, Inc.*,¹²⁸ Justice Blackmun observed that causation is a "far more complex issue" in tender offer fraud cases than it is in section 10(b) cases. When, as in *Piper*, the plaintiff's alleged injury is the "failure to acquire control of

fixed at the time of the transaction, posttransaction price movements or events are irrelevant to the issue of whether plaintiffs can show that the defendant's conduct caused their losses.

124. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1977). The action was brought under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1988), and SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1990), for fraud in the solicitation of proxies.

125. *Mills*, 396 U.S. at 385 n.7. In granting certiorari from *Sandberg v. Virginia Bankshares*, 891 F.2d 1112 (4th Cir. 1989), *cert. granted in part*, 110 S. Ct. 1921 (1990), the Court appears ready to address this unresolved question. *Sandberg* held that "even when the minority's voting strength is insufficient to halt a merger," reliance is not an "element of causation in a Section 14(a) action." 891 F.2d at 1121.

126. *Mills*, 396 U.S. at 388.

127. *Id.*

128. 430 U.S. 1, 51 (1977) (Blackmun, J., concurring).

the target corporation,” the plaintiff must prove that the defendant’s conduct “altered” the outcome of the control contest.¹²⁹ With regard to shareholders of the target corporation, which the Court suggested had standing to recover damages under section 14(e),¹³⁰ causation is apparently far less complex. Upon the shareholders’ claim that the defendant’s fraud altered the price that they accepted for their shares, they may recover the difference between that transaction price and the true value of their shares at the time of the transaction. That loss is recoverable without any showing that the outcome of the control contest may have resulted in additional losses. Although the Supreme Court has recognized the difficult causation problems associated with proving that proxy or tender offer fraud resulted in eventual losses occasioned by the outcome of the control contest, it has never suggested, even in those contexts, that plaintiffs must confront those problems in recovering the difference between their transaction price and the value of their securities at the time of the transaction.

C. Causation In Common Law Fraud Cases

Courts have relied on the common law in support of requiring section 10(b) plaintiffs to prove, as a condition of recovery, that the defendant’s conduct caused their losses.¹³¹ Whether the elements of section 10(b) should mirror the elements of common law fraud is the subject of much debate.¹³² The debate is irrelevant here. If, as the Supreme Court recently suggested, the federal securities laws are designed to “add to the protections provided investors by the common law,”¹³³ then courts developing a rule of section 10(b) causation should not be bound by common law principles of causation. Yet, even if the common

129. *Id.* at 51.

130. *See id.* at 42 n.28 (leaving open the issue whether shareholder-offerees have standing to sue under § 14(e)).

131. *See, e.g.,* Bastian v. Petren Resources Corp., 892 F.2d 680, 684 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

132. *Compare* Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988) (“Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law”) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-45 (1975)) and Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983) (section 10(b) remedies designed to supplement the common law) with Chiarella v. United States, 445 U.S. 222, 228 (1980) (“[T]he duty to disclose arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.’” (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976))).

133. *Basic*, 485 U.S. at 244 n.22.

law were an appropriate model for section 10(b), the common law model of causation does not require fraud victims to prove as a condition to recovery that the defendant's conduct caused a decline in the value of their investments.

Prosser and the Restatement of Torts are typically cited for the position that plaintiffs alleging fraud in connection with a stock transaction must prove that the misrepresentations or omissions caused their economic losses: "[I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate [sic] to the representation will not afford any basis for recovery."¹³⁴ Neither authority supports the position.

Prosser addresses the stock fraud scenario in the context of damages, not in the context of causation. The treatise actually states:

Where, as is commonly the case, the defendant's actionable misrepresentation or non-disclosure induces a transaction that involves the transfer of something of value, courts normally resort to a general measure of damages often referred to as direct damages, and, in addition thereto, will allow such other damages as special or consequential damages as the plaintiff can prove.¹³⁵

If the plaintiff seeks to recover as "loss" the difference between what he transferred and what he would have transferred absent the fraud, that loss is recoverable without regard to the subsequent performance of the stock. But, when, and only when, the plaintiff seeks in addition to recover consequential or special damages, plaintiff must show that subsequent decline in stock value was caused by the fraud. The stock fraud hypothetical is offered by Prosser only as an example of the unavailability of *consequential* damages in some cases. It does not, and of course could not, stand for the proposition that in order to recover "direct damages," plaintiffs must prove that the defendant's conduct caused their "consequential" damages.

134. W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON TORTS § 110, at 767 (5th ed. 1984) [hereinafter W. KEETON]. See also W. PROSSER, THE HANDBOOK OF THE LAW OF TORTS § 110, at 732 (4th ed. 1971), quoted in *Marbury Management*, 629 F.2d at 718. The Restatement (Second) of Torts contains a similar example: "[T]here is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition." *Marbury Management*, 629 F.2d at 719 (quoting RESTATEMENT (SECOND) OF TORTS § 549A (1976)).

135. W. KEETON, *supra* note 134, § 110, at 766.

Nor does the Restatement support that result. Like Prosser, the Restatement makes clear that the posttransaction decline in the value of stock not caused by the defendant's conduct cannot be recovered.¹³⁶ But, like Prosser, the Restatement also makes clear that the posttransaction decline in the value of stock is not the only recoverable loss in a fraud action. In its very next section, the Restatement states that the fraud victim may recover the "pecuniary loss to him of which the misrepresentation is the legal cause,"¹³⁷ and includes with that recoverable loss both the "difference between the value of what he has received in the transaction and its purchase price"¹³⁸ and additional "loss suffered otherwise as a consequence"¹³⁹ Plaintiffs may recover the difference between their purchase price and the value of the security at the time of the transaction without proving that the defendants caused the additional loss suffered otherwise as a consequence.¹⁴⁰

The common law fraud cases from which this understanding of causation evolved are consistent in their views of loss and of causation. In *Waddell v. White*,¹⁴¹ cited by Prosser and Keeton as primary authority for the unrecoverability of losses unrelated to the defendant's misrepresentation,¹⁴² the court distinguishes between two types of recoverable losses.¹⁴³ The plaintiff, who proved that he had been fraudulently induced to sell his land to the defendants for an interest in their company, could clearly recover the loss he suffered by selling his land cheaper than he would have had he known the facts concealed.¹⁴⁴ If, in addition, however, the plaintiff wished to recover losses in the form of the posttransaction decline in the value of his investment, he could do so to the extent that those losses "reasonably resulted" from the defendant's conduct.¹⁴⁵

The common law case of *Hotaling v. A.B. Leach & Co.*¹⁴⁶ is similar. That case has been specifically relied upon as support for requiring plaintiffs to prove defendant's conduct caused their posttransaction losses as a condition to their recovery of any damages under the securities

136. RESTATEMENT (SECOND) OF TORTS § 548A (1976).

137. *Id.* § 549.

138. *Id.*

139. *Id.*

140. The leading common law authorities also clarify that even consequential damages may be recovered in a fraud action when the subsequent "events" are merely "reasonably foreseeable." W. KEETON, *supra* note 134, § 110, at 767. See also RESTATEMENT (SECOND) OF TORTS § 549 (1976).

141. 56 Ariz. 420, 108 P.2d 565 (1940).

142. W. KEETON, *supra* note 134, § 110, at 767 n.25.

143. *Waddell*, 56 Ariz. 420, 108 P.2d 565.

144. *Id.* at 436, 108 P.2d at 572.

145. *Id.*

146. 247 N.Y. 84, 159 N.E. 870 (1928).

laws.¹⁴⁷ The case, however, permits the defrauded plaintiffs to recover the difference between the price they paid for their bonds and the value of the bonds at the time of the transaction without any showing that the defendant's conduct caused any posttransaction decline in value of their investment.¹⁴⁸ If, but only if, plaintiffs wish to recover for additional losses in the form of the posttransaction decline in the value of their bonds, they must somehow link the fraud and those losses.¹⁴⁹ Even those losses could be recovered when the decline would not have occurred, or would not have been as marked, absent the misrepresentations or omissions.¹⁵⁰

Although the common law allows recovery of the posttransaction decline in value in some cases, it does not require the plaintiff to prove that the defendant's conduct caused that decline as a prerequisite to recovering the difference between the transaction price and the true value at the time of the transaction.

D. The Potential for Unlimited Exposure

Courts imposing upon plaintiffs the burden of proving that the defendant's conduct caused their losses ultimately warn that the absence of such a requirement would give Rule 10b-5 a "limitless thrust,"¹⁵¹ creating a "scheme of investors' insurance"¹⁵² that would render defen-

147. See *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (Meskill, J., dissenting).

148. *Hotaling*, 247 N.Y. at 91, 159 N.E. at 872.

149. *Id.* at 91, 159 N.E. at 873.

150. *Id.* Professor Merritt states that the common law does not preclude recovery of losses even when the plaintiff does not show causation. Merritt, *supra* note 16, at 496-97. As this Article demonstrates, however, the issue of causation cannot be separated from the loss that plaintiffs are seeking to redress. Professor Merritt perhaps unwittingly demonstrates that the common law allows recovery of the difference between the transaction price and the true value of the securities at the time of the transaction. It generally does not allow recovery of posttransaction declines absent a showing of foreseeability or linkage. The point of "loss causation" is that in order to recover loss in the form of price-value differences at the time of the transaction, plaintiffs must prove that the defendant's conduct caused the posttransaction decline in the value of their investment. There is no support whatsoever at common law for that position.

151. *Marbury Management*, 629 F.2d at 718 (Meskill, J., dissenting) (citing *Titan Group, Inc. v. Fagen*, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975)).

152. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965). See also *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. Unit A Mar. 1981) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

dants "liable to all the world."¹⁵³ The warning stems from two very different arguments, one based on expanding the class of plaintiffs ("the world") to which defendants might be liable, and the other based on insuring investors against stock decline by allowing them always to recover the initial cost of their investments. Neither argument has merit.

The element of causation in a Rule 10b-5 case does not affect the class of plaintiffs to whom persons who make material misstatements or omissions in connection with the purchase or sale of securities may be liable. The issue of which persons harmed by material misrepresentations or omissions may bring a Rule 10b-5 action is one of standing, not one of causation. In order to have standing to assert a Rule 10b-5 action, plaintiffs must have purchased or sold a security.¹⁵⁴ Moreover, in order to be liable under Rule 10b-5, defendants must at least have made a material misstatement or omission in connection with the plaintiff's purchase or sale of securities.¹⁵⁵ A material misrepresentation or omission is one that has a "substantial likelihood" of altering the "total mix" of information made available to the reasonable investor.¹⁵⁶ When the defendant's conduct has a substantial likelihood of altering the mix of information available to a reasonable investor, such conduct will have altered the price at which a reasonable investor purchased or sold securities.¹⁵⁷ Defendants who make material misrepresentations or omissions in connection with the plaintiff's purchase or sale of securities, therefore, will alter the price at which the plaintiff purchased or sold the securities. Liability runs to all defendants who make such material misrepresentations or omissions and only to the defendants who do so. Adding an independent element of causation will not reduce the number or kind of plaintiffs to whom defendants may be liable.

The absence of an independent causation element does not force defendants to insure investors against trading losses. A defendant who

153. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969) ("causation must be proved else defendants would be liable to all the world"), *cert. denied*, 397 U.S. 913 (1970).

154. *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 737 (1975).

155. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (breach of fiduciary duty absent material misrepresentation or omission insufficient to establish 10b-5 liability); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 9 (1971) (material misrepresentation or omission must be in connection with the purchase or sale of securities).

156. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (defining materiality for 10b-5 purposes).

157. I have previously shown that a material omission is one that alters the price at which a reasonable investor is willing to purchase or sell securities. *See, e.g., Kaufman, The Uniform Rule of Liability Under the Federal Securities Laws: The Judicial Creation of a Comprehensive Scheme of Investor Insurance*, 63 TEMP. L. REV. 61, 63-64 (1990).

utters a material misstatement in connection with the purchase or sale of securities will be liable for the difference that his misstatement creates between the transaction price and the true value of the securities at the time of the transaction.¹⁵⁸ Because that recoverable loss is measured at the time of the transaction, any posttransaction decline in the value of securities is irrelevant to its recoverability. When posttransaction declines are irrelevant, so too is the issue of what caused them. Accordingly, whether an independent causation element exists is irrelevant to the loss traditionally recoverable under Rule 10b-5.

The only way in which Rule 10b-5 plaintiffs may recover their full transaction price is when they successfully obtain full rescissory damages. Under this theory of recovery, plaintiffs theoretically may recover their entire purchase price in return for the value of their investments at the time the fraud is discovered.¹⁵⁹ To the extent this measure of recovery allows plaintiffs to recover any posttransaction decline in the value of their securities that are not merely reflective of the differences between the transaction price and the true value of the securities at the time of the transaction,¹⁶⁰ the measure of recovery may be troublesome. But it

158. The Supreme Court and the circuit courts agree that the plaintiffs may recover out-of-pocket damages. *See, e.g.,* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) (Douglas, J., concurring in part and dissenting in part) (proper measure of damages is difference between fair value seller received and fair value of what seller would have received absent fraudulent conduct). *See also* *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 443 (7th Cir. 1987) (damages must be based on comparison of transaction price and expected value of shares), *cert. dismissed*, 485 U.S. 901 (1988); *Smoky Greenshaw Cotton Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 785 F.2d 1274, 1278 (5th Cir. 1986) (traditional measure of damages in 10b-5 action is out-of-pocket rule), *cert. denied*, 482 U.S. 928 (1987); *Alna Capital Assocs. v. Wagner*, 758 F.2d 562, 566 (11th Cir. 1985) (in securities fraud, out-of-pocket damages rule applies); *Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10th Cir. 1982) (customary measure of damages in Rule 10b-5 cases is out-of-pocket rule); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190 (3d Cir. 1981) (measure of damages is difference between what buyer paid for stock and what buyer would have paid absent fraud), *cert. denied*, 455 U.S. 938 (1982); *Holmes v. Bateson*, 583 F.2d 542, 562 (1st Cir. 1978) (measure of damages is difference between fair value of what seller received and fair value of what seller would have received absent fraud); *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977) (rescissory damages appropriate; allow plaintiff to recover difference between purchase and resale price), *cert. denied*, 435 U.S. 951 (1978); *Nickels v. Koehler Management Corp.*, 541 F.2d 611, 617 (6th Cir. 1976) (proper measure of damages is difference between value of property as represented and actual value at time of sale), *cert. denied*, 429 U.S. 1074 (1977); *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975) (out-of-pocket loss is ordinary measure of damages in 10b-5 suit), *cert. denied*, 429 U.S. 816 (1976); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) (defrauded seller can recover not only difference between actual value and sale value, but added profits realized by buyer).

159. *See, e.g.,* *Jordan v. Duff & Phelps*, 815 F.2d 429, 440 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

160. In Section IV, this Article shows that rescissory damages are awarded *only* to

is that troublesome measure of recovery and not the absence of an independent causation requirement that has the potential for insuring investors against market declines.

To illustrate the need for an independent causation requirement lest Rule 10b-5 become an insurance plan for investors, the court in *Huddleston v. Herman & MacLean*¹⁶¹ hypothesizes an investor who purchases stock in a shipping venture in reliance upon a material misrepresentation about the vessel's capacity. The vessel, which is the venture's only asset, later sinks "as a result of" a casualty unrelated to the misrepresentation itself, and the stock becomes worthless. The Court concludes that a factfinder may find that the investor relied upon the material misrepresentation in purchasing the stock, but that the material misrepresentation nonetheless did not "cause the loss."¹⁶²

The hypothetical is persuasive. It seems to demonstrate the point that absent any requirement that the plaintiff prove that the defendant's conduct "caused the loss," the defendant would become an insurer against even the most unforeseeable casualties. But, what does the Court mean by "loss"? In this context, the "loss" could mean at least the following: (1) the loss of the vessel's crew and the damages associated with that loss; (2) the replacement cost of the sunken vessel; (3) the loss to the venture of expected profits from the vessel; (4) the loss of the shipping venture's sole asset; (5) the loss of the investor's expected profits from his investment in the shipping venture; (6) the loss of the full amount of the investor's consideration paid for the shipping venture investment; or (7) the loss of the amount of consideration paid by the investor for the investment that would not have been paid absent the misrepresentation regarding the vessel's capacity.

The first four types of loss are those suffered directly by the vessel's crew or the venture itself as a result of the casualty. No one would suggest that the ship's crew or even the venture could bring any Rule 10b-5 action against the misrepresenter of the vessel's capacity for these losses. The misrepresentation did not cause the vessel to sink. To the extent that the Court's point is that the misrepresenter cannot be liable to the crew or the venture for such losses, the point is self-evident.

The remaining types of losses are those suffered not by the ship's crew or the venture, but by investors in the venture. Because these investors necessarily purchased a "security" within the meaning of the

the extent that they reflect the amount of the disparity created by the defendants' conduct between the transaction price and the true value of the securities at the time of the transaction.

161. 640 F.2d 534 (5th Cir. Unit A Mar. 1981), *cert. granted*, 456 U.S. 914 (1982), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

162. *Huddleston*, 640 F.2d at 549 n.25.

1934 Act, they purchased something other than a vessel.¹⁶³ Rather, they purchased an expectation of profits from the managerial efforts of those controlling the venture. There is no doubt that the investor suffered an economic loss — lost profits and lost consideration for the purchase of the investment. Nor is there any question that the misrepresentation did not cause the entire loss of all profits from the venture or the entire loss of consideration paid for the purchase price of the investment. To the extent that the court's point is that the misrepresenter cannot be liable for the investor's entire losses, including those caused by the casualty, the point is also self-evident.

The only difficult issue indirectly raised by the court's hypothetical is whether the misrepresenter can be liable to the investor for that amount of the purchase price for the investment that would not have been paid absent the misrepresentation. In the remainder of its opinion, however, the court makes clear that the misrepresenter *can* recover that loss. The court concludes that an investor may recover if he can show that the misrepresentation created a "difference between the price paid and the 'real' value of the security, *i.e.*, the fair market value absent the misrepresentations, at the time of the initial purchase by the defrauded buyer."¹⁶⁴ Suppose, therefore, in the court's hypothetical, the investor had paid \$100 for a share of stock in the shipping venture; the real or fair market value of the stock would have been only \$75 absent the misrepresentation, and the stock after the casualty has become worthless. In one sense, the investor has lost (in addition to profits) the entire \$100 paid as consideration for the investment. As the court's hypothetical suggests, a factfinder may well determine that the misrepresentation did not cause that entire loss. But, as the remainder of the court's opinion confirms, there is no doubt that the investor could recover \$25 — the difference between the amount of consideration actually paid (\$100) and the amount of consideration that would have been paid absent the challenged misrepresentation (\$75). No fact-finder could determine that the misrepresentation did not cause *that* loss. Nor will allowing recovery of that precise loss create a scheme of investor insurance.

163. The hypothetical assumes the application of Rule 10b-5, which in turn presumes the purchase or sale of a security within the meaning of § 3(2) of the 1934 Act, 15 U.S.C. § 78c(2) (1988). If the investment instrument is labeled "stock," it nonetheless will not be a security unless it has attributes commonly associated with stock ownership, such as an expectation of profits. If instead the instrument is not labeled stock, but is still deemed to be a security, it necessarily is an investment in a common enterprise when the investor is led to expect profits from the efforts of others. *See Reves v. Ernst & Young*, 110 S. Ct. 945 (1990).

164. *Huddleston*, 640 F.2d at 556.

IV. TOWARD THE ABANDONMENT OF LOSS CAUSATION

The preceding section of this Article shows that no support for requiring Rule 10b-5 plaintiffs to prove that the defendant's conduct caused the posttransaction decline in the value of their investments can be found. This section demonstrates that in the absence of any real support, the independent element of "loss causation" has no place in a Rule 10b-5 action. Although one court has suggested that the phrase "loss causation" is "confusing" because it diverts judicial attention from the kind of transactions protected by Rule 10b-5,¹⁶⁵ the phrase is more confusing because it diverts judicial attention from the kind of losses that are recoverable under Rule 10b-5. The concept should be abandoned in favor of a rule of liability and damages that recognizes that the only losses recoverable in a Rule 10b-5 case are those fixed at the time of the securities transaction by the defendant's material misstatement or omission.

The measure of damages in all Rule 10b-5 actions is determined as of the time of the transaction. The Supreme Court and the circuit courts agree that the typical measure of damages in Rule 10b-5 cases is the out-of-pocket rule.¹⁶⁶ The plaintiff under that measure may recover the difference between the price at which the stock was traded and its fair value, measured as of the time of the transaction.¹⁶⁷

Although the federal courts may be moving in the direction of encouraging a rescissory measure of damages under Rule 10b-5,¹⁶⁸ even this measure attempts to fix damages at the time of the transaction. Numerous devices have been used to arrive at the amount of rescissory damages. The full purchase price will be returned when the defendant has induced the plaintiff to enter the market in the first place; in other words, when the omissions or misstatements are so material that they have induced an investment rather than a price.¹⁶⁹ The difference between the purchase price and the plaintiff's resale price within a reasonable

165. *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.) ("the terms 'loss causation' and 'transaction causation' . . . have been confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws"), *cert. denied*, 109 S. Ct. 311 (1988).

166. *See supra* note 158 and cases cited therein.

167. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972).

168. *See Easterbrook & Fischel, Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985) (law of damages in security cases's comprised of simple principles leading to intelligible rules of damages based on net harm offender's acts caused others).

169. *See, e.g., Nelson v. Serwald*, 576 F.2d 1332, 1338-39 (9th Cir.) (proper measure of damages is defendant's profit when defendant made material omissions as to value of stock and defendant's gain from ultimate sale of stock was greater than plaintiff's loss for selling stock to defendant at below fair market value), *cert. denied*, 439 U.S. 970 (1978).

time after discovery of the fraud will be used when the defendant concealed facts so material that a reasonable investor could have deduced from them the resale price.¹⁷⁰ Conversely, when the plaintiff is a seller, the disparity between purchase price and the plaintiff's cost of covering by repurchasing the stock a reasonable time after discovery of the fraud may be used when the misstatements or omissions induced the plaintiff to forfeit the repurchase opportunity.¹⁷¹

The resale price measure and the cover measure both limit rescissory recovery to a measure of the materiality of the challenged misstatements or omissions assessed at the time of the transaction.¹⁷² They have been compared to the Uniform Commercial Code's damages provisions that foster beneficial postbreach commercial activity by limiting damages to a measure of the precise wrong, also measured as of the date of the transaction.¹⁷³

The judicial use of equitable limits on rescissory relief has the same effect. Although privity is no longer a requirement for rescission, promptness or diligence generally is.¹⁷⁴ Requiring the plaintiff to make a prompt election of rescission mitigates the plaintiff's damages to the disparity between the price paid and the fair value of the stock at the time of the transaction. If rescission is prompt, that disparity can be determined at a date close to the transaction date, or better still, at a date that reflects a fully informed market price.

170. *See, e.g.*, *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J., concurring) (recovery of out-of-pocket damages possible when sales price of stock before fraud discovered exceeded original purchase price).

171. *See, e.g.*, *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 105-06 (10th Cir.) (when investors sold stock as result of deceptively gloomy press release, proper measure of damages is amount investors would have needed to reinvest within reasonable period of being informed by curative press release), *cert. denied*, 404 U.S. 1004 (1971).

172. *See Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360-61 (8th Cir. 1977) (when investor was fraudulently induced to participate in bond merger account program, rescissory damages measure properly applied), *cert. denied*, 435 U.S. 951 (1978); *Chasins v. Smith, Barney & Co.*, 306 F. Supp. 177, 178-79 (S.D.N.Y. 1969) (difference between purchase price and sale price proper measure of damages when plaintiff did not become aware of material omission until after stock sold at loss), *aff'd*, 438 F.2d 1167 (2nd Cir. 1970).

173. *Jordan v. Duff & Phelps*, 815 F.2d 429, 440 (7th Cir. 1987) (UCC limits seller's damages to unpaid contract price less market price at time of delivery, providing incentive to sell on market; purchaser's damages limited to market price at time breach discovered less contract price, providing incentive to cover) (citing U.C.C. §§ 2-706, -708, -711, -713), *cert. dismissed*, 485 U.S. 901 (1988).

174. *See id.* at 440 (prompt demand for rescission important in allocating risks among parties because allowing belated election between market damages and rescission effectively lets investor do both and subjects defendant to damages greater than loss actually suffered).

Under the labels of the resale measure, the cover measure, or equitable limits on rescission, courts have fashioned relief that approximates the difference between the price and the value of the security at the time of the transaction. Although courts find generally that the out-of-pocket measure or rescissionary measure of damages are viable alternatives, they have applied those measures only as evidentiary tools to a single end — fixing loss at the moment of the transaction.

Because the only loss recoverable under Rule 10b-5 is the difference between the price and the value of the security at the time of the transaction, any posttransaction decline in value of a plaintiff's investment can never in itself provide the basis for recovery. Instead, posttransaction declines — particularly those that follow the disclosure of the fraud — may at most provide the evidentiary starting point for an analysis of the amount by which the fraud altered the transaction price. Posttransaction declines are evidence of loss, they are not loss itself. Accordingly, whether the defendant's conduct causes a posttransaction decline is irrelevant to the issue of whether the defendant's conduct causes loss. The issue of whether the defendant's conduct has caused loss thus reduces to whether the defendant's misstatement or omission has created a disparity between the transaction price and the value of the security at the time of the transaction.

The terms "transaction causation" and "loss causation" should therefore be abandoned entirely as independent concepts. They should be replaced by the singular requirement that the plaintiff show that the defendant's misstatement or omission created a disparity between the transaction price and the value of the securities at the time of the transaction.

V. LIFE AFTER LOSS CAUSATION

The application of this singular concept clarifies and reconciles the apparent conflicts within courts.¹⁷⁵ For example, the observed split in

175. See *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.) (noting that "such conflict as there is appears to be within rather than among circuits"), *cert. denied*, 110 S. Ct. 2590 (1990). One scholar has observed that courts have distinguished securities cases against brokers or persons in privity with the plaintiff from all others, as those in which the plaintiff may recover damages in the amount of the full posttransaction decline in the value of his investment. Merritt, *supra* note 16, at 510-15. Professor Merritt then argues that the distinction is invalid and that all plaintiffs should be able to recover their "gross losses" when the defendant cannot prove the absence of causation. *Id.*

The distinction on which Merritt premises his critique, however, is a false one. The observed distinction between loss recoverable in privity as opposed to nonprivity cases is based entirely upon Judge Sneed's concurrence in *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976). See Merritt, *supra* note 16, at 511-13 (citing *Green*, 541

the Second Circuit on the issue of loss causation is reconcilable. In *Marbury Management* itself, the majority and the dissent both find that the defendant's misrepresentation created a difference between the price plaintiffs paid for their securities and the price they would have paid absent the misrepresentations. There, a trainee in a brokerage firm misrepresented his expertise, inducing plaintiffs to overcome their misgivings and purchase securities that later declined in value. In addressing the issue of causation, both the majority and the dissent relied heavily upon the common law for the view that only losses proximately caused

F.2d 1335 (Sneed, J., concurring). The concurrence is criticized for its apparent distinction between privity cases in which rescissory damages are recoverable and nonprivity, open market cases in which only out-of-pocket damages are recoverable. Merritt, *supra* note 16, at 512-13. But the reason rescissory damages are generally employed in privity and generally not employed in nonprivity cases is not *because* of privity or its absence. Rather, a rescissory method of measuring damages is generally a useful tool in nonopen market cases because the posttransaction value or resale price of the security is the only indicium of the security's value at the time of the transaction. When plaintiff sues, as plaintiff must to recover rescissory damages, a reasonable time after the disclosure of the fraud, the postdisclosure value or resale price of the security is the only evidence of the value of the concealed information. In open market transactions, by contrast, when the market price impounds all available information about the security, the difference between that price and the true value of the securities at the time of the transaction can be measured without reference to the plaintiff's posttransaction conduct because the drop in market price when the fraud is disclosed is strong evidence of the value of the concealed information. Thus, although rescissory concepts may appear in privity cases, those concepts are merely tools used in such cases by courts to determine the price-value disparity created by concealed information at the time of the transaction.

The observed "exception" for broker-dealer fraud is similarly misunderstood. Professor Merritt cites *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980), and *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978), as prime examples of an award of full losses *because* they involved broker-dealers. Yet, those cases employed a rescissory damage measure not because they involved broker-dealers, but because the misrepresentations made by the broker-dealers were so material as to induce the plaintiffs to part with their entire purchase price. In *Marbury Management*, the plaintiff received his entire purchase price discounted by any residual value of his securities because the gross misrepresentation of the broker's expertise altered not just the price at which the plaintiff decided to invest, but the very decision to invest. 629 F.2d at 708. Similarly, in *Garnatz*, the Eighth Circuit allowed the investor to obtain rescissory damages representing his full purchase price not because the defendant was a broker, but because the broker's misrepresentations about the marketability of the bond were so material that they, too, altered the very decision to invest. 559 F.2d at 1361. When, as in *Garnatz* and *Marbury Management*, the "gravamen" of the plaintiff's complaint is not that the plaintiff bought at an unfair price, but that the plaintiff bought at all, a rescissory measure of calculating loss is an accurate approximation of the materiality of the challenged misrepresentations and omissions. Thus, "gross loss" is never a proper measure of "loss" in a securities case — not even in privity or broker-dealer cases. However, gross loss can, in these contexts, serve as important evidence of the recoverable loss that is fixed as of the date of the transaction.

by the misrepresentation could be recovered.¹⁷⁶ Both also agreed that the relevant date for fixing losses is the date of sale.¹⁷⁷

Where the opinions truly diverge is in their assessments of the materiality of the trainee's misrepresentation that he was a "portfolio management specialist." In affirming the lower court's award of damages as the difference between the transaction price and the posttransaction value of their securities, the majority reasoned that the trainee's misstatements were so material that in their absence plaintiffs, particularly given their trepidations, would not have invested at all.¹⁷⁸ The misrepresentations therefore created a disparity between the plaintiffs' transaction price and the amount they would have paid had they known the truth, which was equivalent to the full transaction price. Judge Meskill, by contrast, did not share the majority's belief that the misrepresentations were so material. He reasoned that the misrepresentations may have altered the initial price at which plaintiffs invested, but they were not so strong as to alter plaintiffs' very decision to invest.¹⁷⁹ Although the judges have different views of the materiality of the misrepresentation — an issue ultimately for the factfinder — they do not have different views of the application of causation to Rule 10b-5 actions.

Judge Meskill's subsequent majority opinion in *Bennett v. United States*¹⁸⁰ is similarly reconcilable. The Bennetts alleged that the defendants loaned them money based on the misrepresentation that the Federal Reserve's margin rules do not apply to a public utility stock deposited with a bank as collateral. In concluding that the Bennetts could not recover for the decline in value of securities purchased with the loans, Judge Meskill reasoned that the misrepresentation was not material; it had no effect on whether and at what price plaintiffs were induced to trade in securities.¹⁸¹

Judge Meskill himself reasoned that the result is consistent with *Marbury Management*. He observed that the "essence" of *Marbury Management* is that the "stock in question did not have the value represented by the 'broker.'"¹⁸² The misrepresentation there was so

176. See *Marbury Management*, 629 F.2d at 708-10; *id.* at 717-23 (Meskill, J., dissenting).

177. Judge Meskill's dissent, of course, rejects the recovery of posttransaction declines in value. *Id.* at 723 (Meskill, J., dissenting). But, even the majority, in affirming the first court's computation of damages, recognizes that stock prices on dates subsequent to the transactions are evidence of the loss fixed on the date of the transactions. *Id.* at 707, 709.

178. *Id.* at 708.

179. *Id.* at 723 (Meskill, J., dissenting).

180. 770 F.2d 308 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986).

181. *Id.* at 314.

182. *Id.*

material that it “both induced the purchase and related to the stock’s value.”¹⁸³ In *Bennett*, by contrast, the misrepresentation was not material — it “neither induced the purchase nor related to the stock’s value.”¹⁸⁴ Despite the apparent differences in rhetoric, the Second Circuit is consistent: plaintiffs may recover damages when the defendant’s misrepresentation or omission creates a difference between the transaction price and the value of the securities at the time of the transaction.

The Eleventh Circuit shares this consistent view. In *Currie v. Cayman Resources Corp.*, that court affirmed the grant of directed verdict against an investor in a limited partnership because the investor could not show a “causal relationship between the alleged untruths and his pecuniary loss.”¹⁸⁵ In *Bruschi v. Brown*,¹⁸⁶ that court reversed the summary judgment against an investor, reasoning that the investor had created a factual issue as to whether defendants caused her losses.¹⁸⁷ The cases are identical, however, in their analysis of the requirements of proving “loss causation.” The plaintiff in *Currie* failed to prove “loss causation” because he could not show that the consideration he received in exchange for his securities was less than it would have been absent the misrepresentation.¹⁸⁸ The plaintiff in *Bruschi*, on the other hand, avoided summary judgment by creating a factual issue as to whether the defendant “caused her losses by misrepresenting the intrinsic worth of the . . . securities as of the time of the misrepresentations.”¹⁸⁹ The results are different, but the reasoning is the same. The concept of loss causation discussed at length in both cases is irrelevant to that reasoning. When the defendant’s misstatement or omission alters the transaction price, plaintiffs can recover the amount by which the price was altered.

Even the strong, divergent views of causation developing in the Seventh Circuit have this principle in common. In *LHLC Corp. v. Cluett, Peabody & Co.*,¹⁹⁰ Judge Easterbrook, after criticizing the terms “transaction causation” and “loss causation,” collapsed the two concepts into a single appropriate inquiry as to “whether the information disclosed or withheld effected an *investment* decision.”¹⁹¹ According to Judge

183. *Id.*

184. *Id.*

185. 835 F.2d 780, 785 (11th Cir. 1988).

186. 876 F.2d 1526, 1530-31 (11th Cir. 1989).

187. *Id.* at 1531.

188. *Currie*, 835 F.2d at 785.

189. 876 F.2d at 1531. Although *Bruschi* suggests that even posttransaction declines in value may be recovered when the defendant’s representations are “inherently related” to the subsequent losses, the court remands for trial on the issue of loss as of the time of the transaction. *Id.*

190. *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928 (7th Cir. 1988).

191. *Id.* at 931 (emphasis in original).

Easterbrook, information that affects an investment decision is information that alters the price of the transaction, or the decision to invest. Such price-altering information is deemed "material" information by federal securities laws.¹⁹² Accordingly, when the defendant utters a material misrepresentation, the utterance by definition creates a disparity between the transaction price and the value of the securities at the time of the transaction. If, as the court suggests, a misrepresentation or omission is truly material, it will always "cause" recoverable losses. In order to recover under Rule 10b-5, therefore, plaintiffs need only show that the defendant's misrepresentation or omission was material; they need not show that the defendant's conduct caused any posttransaction price movement.

Indeed, in a case subsequent to *LHLC*, Judge Easterbrook declared that posttransaction price movements were so irrelevant to the issues of loss and causation under Rule 10b-5 that a plaintiff could recover damages even when the value of his investment *increased* after the transaction. In *Goldberg v. Household Bank F.S.B.*,¹⁹³ the court makes explicit what is implicit in many other loss causation opinions: the "drop" in market price "when the truth appears is a good measure of the value of the information, making it the appropriate measure of damages."¹⁹⁴ Post-transaction price-drops are only relevant as a measure of the value of the information concealed at the time of the transaction. A plaintiff's recoverable loss is equivalent to the value of that concealed information. When a defendant conceals information of value to a securities transaction, therefore, he causes a recoverable loss. Information of value to a securities transaction is material information. Accordingly, a defendant who conceals material information causes recoverable losses under the securities laws.¹⁹⁵

That the requirement of "loss causation" is indistinguishable from the requirement of materiality is further demonstrated by a close examination of the Seventh Circuit's decisions in *Bastian*¹⁹⁶ and *DiLeo*.¹⁹⁷ In *Bastian*, the district court dismissed plaintiffs' Rule 10b-5 claim.

192. *Id.* "But materiality usually refers to the importance of the information; a datum that would have only a small effect on the price is not material, while a datum with the potential for a larger effect is." *Id.*

193. 890 F.2d 965 (7th Cir. 1989).

194. *Id.* at 966-67.

195. Because loss is a function of the materiality of the concealed information at the time of the transaction, the court declared, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss." *Id.* at 966.

196. *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990).

197. *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990).

Although their complaint alleged that “but for” the defendant’s misrepresentations concerning their integrity and competence, plaintiffs would not have invested in a failed oil and gas limited partnership, plaintiffs failed to allege that the defendant’s misrepresentations actually caused their investments to lose their value.¹⁹⁸ The case raises the issue of whether plaintiffs must allege and ultimately prove in a securities fraud action that the defendant’s conduct was the cause of the decline in the value of their securities. Judge Posner, writing for the Seventh Circuit, seems to opine that plaintiffs must not only allege, but must also sustain the burden of proving that the defendant’s fraud caused the decline in the value of their investments.

In reaching that apparent result, Judge Posner analogizes securities fraud to the law of torts. Loss causation, he opines, is nothing more than “an instance of the common law’s universal requirement that the tort plaintiff prove causation.”¹⁹⁹ He further writes: “‘Loss causation’ is an exotic name perhaps an unhappy one, . . . for the standard rule of tort law that the plaintiff must allege and prove that, but for the defendant’s wrongdoing, the plaintiff would not have incurred the harm of which he complains.”²⁰⁰ As in medical malpractice cases in which the plaintiff must prove that the patient would have lived longer absent the wrong, so too in securities fraud cases, the plaintiffs should have to prove that the investment would have fared better absent the wrong.²⁰¹ According to Judge Posner, it is not enough for the plaintiffs to prove that the defendants caused them to part with their money; rather, they must prove that the defendants caused their investments to fail.²⁰²

In applying this requirement to the allegations in the cases, Judge Posner demonstrated that the issue of (loss) causation is indistinguishable from that of the materiality of the misrepresentations, as of the time of the transaction. The court assumed that the plaintiffs wanted to invest their money in an oil and gas limited partnership, the competence and honesty of the general partners had only limited materiality. In other words, had the plaintiffs known of the defendant’s incompetence, they still would have invested in some oil and gas limited partnership — either the same one at a lower price or a different one at the same price. According to Judge Posner’s reasoning, if the plaintiffs could have shown that the nondisclosures in the case created a disparity between the price a reasonable investor would have paid for an oil and gas

198. *Bastian*, 892 F.2d at 684-85.

199. *Id.* at 684.

200. *Id.* at 685.

201. *Id.* at 684.

202. *Id.*

partnership and the price they actually paid, they would have recovered the amount of that disparity.

Judge Posner's counter-example further proves the point. When a broker gives false assurances to a customer that an investment is "risk-free" and a risk materializes, the customer, according to Judge Posner, may readily establish that the broker caused his losses. In such a case, the customer, if he had known the truth, would presumably not have parted with his money in an equally risky investment. Accordingly, the broker has caused the customer's losses. But in both the broker hypothetical and the oil and gas situation, the defendant's fraud has not actually caused the investment to decline in value. Even the broker cannot be said to be the *actual* cause of the decline in value of the risky stock.

Rather, the two cases are distinguishable based on the different levels of materiality of the two misrepresentations. The nondisclosure of the questionable competence of the general partners in an oil and gas venture is simply less material than the misrepresentation that an investment is risk-free. The broker's misrepresentation is so material, in fact, that the plaintiff may be able to show that he would not have entered into the investment at all had he known the truth, in which case the measure of his recovery would be the entire purchase price. Hence, Judge Posner's own example demonstrates that (loss) causation can be established by showing that the omissions were material — they created a quantifiable disparity between trading price and true value.

In *DiLeo v. Ernst & Young*,²⁰³ however, the Seventh Circuit, through Judge Easterbrook, suggested yet another version of the loss causation requirement. There, plaintiffs alleged that the accounting firm of Ernst & Young was liable under Rule 10b-5 for certifying financial statements that failed to disclose that Continental Bank had not sufficiently increased its reserves to protect itself from troubled loans. The court stated that plaintiffs cannot prevail unless they show that the decline in the price of the stock they purchased "is attributable to fraud,"²⁰⁴ and not simply to failed business performance.

Yet, Judge Easterbrook suggested that it may not be enough even for plaintiffs to prove that the defendant's conduct caused their losses. Instead, he suggested that liability for securities fraud should follow only if the defendant's conduct makes *all* investors worse off:

When a firm loses money in its business operations, investors feel the loss keenly. Shifting these losses from one group of investors to another does not diminish their amplitude, any more

203. 901 F.2d 624 (7th Cir. 1990).

204. *Id.* at 627.

than rearranging the deck chairs on the Titanic prevents its sinking. Revealing the bad loans earlier might have helped the DiLeos, but it would have injured the other investors by an equal amount. The net is a wash.²⁰⁵

Judge Easterbrook here indicated that omissions which do not harm investors as a whole, on a net basis, cannot be the predicate for securities fraud. Such omissions have not caused investor losses or investor injury.

This concept has been previously explored by Judge Easterbrook. First, in a law review article, Judge Easterbrook analogized to the principle of "antitrust injury"²⁰⁶ and reasoned that damages in securities law cases should not be awarded unless the defendant's conduct causes a net loss to all investors.²⁰⁷ Second, Judge Easterbrook in *Flamm v. Eberstadt*²⁰⁸ earlier opined that: "Rule 10b-5 is about *fraud* after all, and it is not fraudulent to conduct business in a way that makes investors better off — that all investors prefer *ex ante* and that most prefer even *ex post*."²⁰⁹ The difficulty with Judge Easterbrook's insistence upon this concept of "securities injury" or "investor net harm" is that the Supreme Court expressly rejected that approach as backwards reasoning from a policy of economic efficiency.²¹⁰

Whether backwards or not, Judge Easterbrook's theory in application merely requires a court to quantify the materiality of a challenged omission. If the DiLeo's had alleged that the failure to disclose the unsatisfactory reserves created a disparity between the price at which they purchased Continental securities and the true value of the securities at the time of the transaction, they could have proved that investors as a whole had suffered because the market for those securities as a whole would have been defrauded. Loss causation or net harm, therefore, are "exotic" names for the difference between transaction price and value created by the defendant's conduct.²¹¹

VI. CONCLUSION

Loss causation became a virtually insurmountable evidentiary barrier to plaintiffs only after transaction causation became an easily surmountable evidentiary barrier. The fact that one concept magically re-

205. *Id.*

206. Easterbrook & Fischel, *supra* note 168, at 647-48.

207. *Id.* at 651.

208. 814 F.2d 1169 (7th Cir.), *cert.denied*, 484 U.S. 853 (1987).

209. *Id.* at 1177.

210. *See* Basic Inc. v. Levinson, 485 U.S. 224, 235 (1988).

211. Rankow v. First Chicago Corp., 870 F.2d 356, 367 (7th Cir. 1989) (citing Kademian v. Ladish, 792 F.2d 614, 628 n.11 (7th Cir. 1986)).

placed the other in prominence suggests that their labels may be unimportant to the judges who employ them. What may be more important to the judiciary is finding some mechanism to insure that before plaintiffs exact from defendants a monetary award, they must show a significant connection between the defendant's unlawful conduct and their losses.

There can be no doubt, however, that anyone who makes a misrepresentation or omission that increases the price at which a reasonable person purchases a security, or decreases the price at which a reasonable person sells a security, causes some loss. Under traditional damages principles, that out-of-pocket loss is plainly recoverable. Yet, if the loss causation confusion continues to grow, plaintiffs will be unable to recover such losses unless they can prove that the misrepresentation or omission also caused a posttransaction decline in the value of their investment.

The source of the loss causation confusion is obvious. It stems from a failure to define the losses that are recoverable under the federal securities laws. The failure is needless. Recoverable loss under those laws is easy to define: it is the difference between the transaction price and the value of a security, measured at the time of the transaction. Although posttransaction declines may provide evidence of these transaction-based losses, posttransaction declines are not in themselves recoverable loss. Indeed, the federal securities laws were not designed to prevent declines in the value of an investment any more than they were designed to encourage increases in the value of an investment. Rather, the fundamental objective of those laws is to insure that investors have full and accurate information from which to decide whether the transaction price of a security reflects its fair value. That fundamental decision, which is what the federal securities laws protect, is of course, made at the time of the transaction.

Because the doctrine of loss causation as it has evolved does not recognize the time of the transaction as the point of potential loss in a securities transaction, it ultimately disserves the very purpose of the securities laws. Only by abandoning the confusing concept of loss causation can courts redress the loss that those laws were truly designed to prevent — the loss to investor autonomy.

