BASIC, INC. v. LEVINSON
485 U.S. 224 (1988)

Justice BLACKMUN delivered the opinion of the Court: This case requires us to . . . determine whether a person who traded a corporation's shares on a securities exchange after the issuance of a materially misleading statement by the corporation may invoke a rebuttable presumption that, in trading, he relied on the integrity of the price set by the market.

I

Prior to December 20, 1978, Basic Incorporated was a publicly traded company primarily engaged in the business of manufacturing chemical refractories for the steel industry. As early as 1965 or 1966, Combustion Engineering, Inc., a company producing mostly alumina-based refractories, expressed some interest in acquiring Basic, but was deterred from pursuing this inclination seriously because of antitrust concerns it then entertained. In 1976, however, regulatory action opened the way to a renewal of Combustion's interest. The "Strategic Plan," dated October 25, 1976, for Combustion's Industrial Products Group included the objective: "Acquire Basic Inc. $30 million."

Beginning in September 1976, Combustion representatives had meetings and telephone conversations with Basic officers and directors, including petitioners here, concerning the possibility of a merger. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations. On December 18, 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release stating that it had been "approached" by another company concerning a merger. On December 19, Basic's board endorsed Combustion's offer of $46 per share for its common stock, and on the following day publicly announced its approval of Combustion's tender offer for all outstanding shares.

Respondents are former Basic shareholders who sold their stock after Basic's first public statement of October 21, 1977, and before the suspension of trading in December 1978. Respondents brought a class action against Basic and its directors, asserting that the defendants issued three false or misleading public statements and thereby were in violation of § 10(b) of the 1934 Act and of Rule 10b-5. Respondents alleged that they were injured by selling Basic shares at artificially depressed prices in a market affected by petitioners' misleading statements and in reliance thereon.

The District Court adopted a presumption of reliance by members of the plaintiff class upon petitioners' public statements that enabled the court to conclude that common questions of fact or law predominated over particular questions pertaining to individual plaintiffs. The District Court therefore certified respondents' class. . . . The United States Court of Appeals for the Sixth Circuit affirmed the class certification . . . . The Court of Appeals joined a number of other circuits in accepting the "fraud-on-the-market theory" to create a rebuttable presumption that respondents relied on petitioners' material misrepresentations, noting that without the presumption it would be impractical to certify a class under Fed.R.Civ.P. 23(b)(3).

We granted certiorari to . . . determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's [false] statements. . . .

IV
A

We turn to the question of reliance and the fraud-on-the-market theory. Succinctly put:

> "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." *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir.1986).

Our task, of course, is not to assess the general validity of the theory, but to consider whether it was proper for the courts below to apply a rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory.

This case required resolution of several common questions of law and fact concerning the falsity or misleading nature of the three public statements made by Basic, the presence or absence of scienter, and the materiality of the misrepresentations, if any. In their amended complaint, the named plaintiffs alleged that in reliance on Basic's statements they sold their shares of Basic stock in the depressed market created by petitioners. Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones. The District Court found that the presumption of reliance created by the fraud-on-the-market theory provided "a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Fed.R.Civ.P.] 23." The District Court thus concluded that with reference to each public statement and its impact upon the open market for Basic shares, common questions predominated over individual questions, as required by Fed.R.Civ.P. 23(a)(2) and (b)(3).

Petitioners and their amici complain that the fraud-on-the-market theory effectively eliminates the requirement that a plaintiff asserting a claim under Rule 10b-5 prove reliance. They note that reliance is and long has been an element of common-law fraud, and argue that because the analogous express right of action includes a reliance requirement, see, e.g., Securities Exchange Act § 18(a), so too must an action implied under § 10(b).

We agree that reliance is an element of a Rule 10b-5 cause of action. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (quoting Senate Report). Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury. . . . There is, however, more than one way to demonstrate the causal connection. Indeed, we previously have dispensed with a requirement of positive proof of reliance, where a duty to disclose material information had been breached, concluding that the necessary nexus between the plaintiffs' injury and the defendant's wrongful conduct had been established. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Similarly, we did not require proof that material omissions or misstatements in a proxy statement decisively affected voting, because the proxy solicitation itself, rather than the defect in the solicitation materials, served as an essential link in the transaction. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-385

(1970).

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.

> "In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as a unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."

In re LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D.Tex.1980). . . .

B

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, see *Affiliated Ute Citizens v. United States*, 406 U.S. at 153-54, or if the misrepresentation had not been made, see *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 188 (3d Cir.1981), cert. denied, 455 U.S. 938 (1982), would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market. . . .

The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the [Exchange] Act. In drafting that Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets. . . .[23]

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.[24] It has been noted that "it is hard to imagine that there ever is a buyer or

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[23] Contrary to the dissent's suggestion, the incentive for investors to "pay attention" to issuers' disclosures comes from their motivation to make a profit, not their attempt to preserve a cause of action under Rule 10b-5. Facilitating an investor's reliance on the market, consistently with Congress' expectations, hardly calls for "dismantling the federal scheme which mandates disclosure."

[24] See In re LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980) (citing studies); Daniel Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.Law. 1, 4 n.9 (1982) (citing literature on efficient-capital-market theory); Roger Dennis, *Materiality and the Efficient Capital*

seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Schlanger v. Four-Phase Systems Inc.,* 555 F.Supp. 535, 538 (S.D.N.Y.1982). Indeed, nearly every [lower] court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed. Commentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory. An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

C

The Court of Appeals found that petitioners "made public, material misrepresentations and [respondents] sold Basic stock in an impersonal, efficient market. Thus the class, as defined by the district court, has established the threshold facts for proving their loss." The court acknowledged that petitioners may rebut proof of the elements giving rise to the presumption, or show that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false.

Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance. For example, if petitioners could show that the "market makers" were privy to the truth about the merger discussions here with Combustion, and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone.[28] Similarly, if, despite petitioners' allegedly fraudulent attempt to manipulate market price, news of the merger discussions credibly entered the market and dissipated the effects of the misstatements, those who traded Basic shares after the corrective statements would have no direct or indirect connection with the fraud.[29] Petitioners also could rebut the presumption of reliance as to plaintiffs who would have divested themselves of their

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Market Model: A Recipe for the Total Mix, 25 Wm. & Mary L.Rev. 373, 374-81 & n.1 (1984). We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.

[28] By accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price. Furthermore, our decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind.

[29] We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial, throughout which the District Court retains the authority to amend the [class] certification order as may be appropriate. Thus, we see no need to engage in the kind of factual analysis the dissent suggests that manifests the "oddities" of applying a rebuttable presumption of reliance in this case.

Basic shares without relying on the integrity of the market. For example, a plaintiff who believed that Basic's statements were false and that Basic was indeed engaged in merger discussions, and who consequently believed that Basic stock was artificially underpriced, but sold his shares nevertheless because of other unrelated concerns, *e.g.*, potential antitrust problems, or political pressures to divest from shares of certain businesses, could not be said to have relied on the integrity of a price he knew had been manipulated.

V

In summary: . . .

5. It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.
6. That presumption, however, is rebuttable.
7. The District Court's certification of the class here was appropriate when made but is subject on remand to such adjustment, if any, as developing circumstances demand. . . .

The Chief Justice, Justice SCALIA, and Justice KENNEDY took no part in the consideration or decision of this case.

Justice WHITE, with whom Justice O'CONNOR joins, . . . dissenting in part: . . . I do not agree that the "fraud-on-the-market" theory should be applied in this case.

I

Even when compared to the relatively youthful private cause-of-action under § 10(b), see *Kardon v. National Gypsum Co.*, 69 F.Supp. 512 (E.D.Pa.1946), the fraud-on-the-market theory is a mere babe. Yet today, the Court embraces this theory with the sweeping confidence usually reserved for more mature legal doctrines. In so doing, I fear that the Court's decision may have many adverse, unintended effects as it is applied and interpreted in the years to come.

A

At the outset, I note that there are portions of the Court's fraud-on-the-market holding with which I am in agreement. Most importantly, the Court rejects the version of that theory, heretofore adopted by some courts, which equates "causation" with "reliance," and permits recovery by a plaintiff who claims merely to have been *harmed* by a material misrepresentation which altered a market price, notwithstanding proof that the plaintiff did not in any way *rely* on that price. I agree with the Court that if Rule 10b-5's reliance requirement is to be left with any content at all, the fraud-on-the-market presumption must be capable of being rebutted by a showing that a plaintiff did not "rely" on the market price. . . .

B

But even as the Court attempts to limit the fraud-on-the-market theory it endorses today, the pitfalls in its approach are revealed by previous uses by the lower courts of the broader versions of the theory. Confusion and contradiction in court rulings are inevitable when traditional legal analysis is replaced with economic theorization by the federal courts.

In general, the case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit. See, *e.g., Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471-477, (1977). Even when we have extended civil liability under Rule 10b-5 to a broader reach than the common law had previously permitted, we have retained familiar legal principles as our guideposts. See, *e.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389-90 (1983). The federal courts have proved adept at developing an evolving jurisprudence of Rule 10b-5 in such a manner. But with no staff economists, no experts schooled in the "efficient-capital-market hypothesis," no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.[4]

. . . Yet the Court today ventures into this area beyond its expertise, beyond -- by its own admission -- the confines of our previous fraud cases. Even if I agreed with the Court that "modern securities markets . . . involving millions of shares changing hands daily" require that the "understanding of Rule 10b-5's reliance requirement" be changed, I prefer that such changes come from Congress in amending § 10(b). . . . In choosing to make these decisions itself, the Court, I fear, embarks on a course that it does not genuinely understand, giving rise to consequences it cannot foresee. . . .[5]

C

At the bottom of the Court's conclusion that the fraud-on-the-market theory sustains a presumption of reliance is the assumption that individuals rely "on the integrity of the market price" when buying or selling stock in "impersonal, well-developed market[s] for securities." Even if I was prepared to accept (as a matter of common sense or general understanding) the assumption that most persons buying or selling stock do so in response to the market price, the

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[4] This view was put well by two commentators who wrote a few years ago:

> Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. . . . Yet the legal culture's remarkably rapid and broad acceptance of an economic concept that did not exist twenty years ago is not matched by an equivalent degree of *understanding*.

Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 Va.L.Rev. 549, 549-550 (1984) (footnotes omitted; emphasis added). While the fraud-on-the-market theory has gained even broader acceptance since 1984, I doubt that it has achieved any greater understanding.

[5] For example, Judge Posner in his *Economic Analysis of Law* § 15.8, pp. 423-24 (3d ed.1986), submits that the fraud-on-the-market theory produces the "economically correct result" in Rule 10b-5 cases but observes that the question of damages under the theory is quite problematic. Notwithstanding the fact that "[a]t first blush it might seem obvious," the proper calculation of damages when the fraud-on-the-market theory is applied must rest on several "assumptions" about "social costs" which are "difficult to quantify." Of course, answers to the question of proper measure of damages in a fraud-on-the-market case are essential for proper implementation of the fraud-on-the-market presumption. Not surprisingly, the difficult damages question is one the Court expressly declines to address today.

fraud-on-the-market theory goes further. For in adopting a "presumption of reliance," the Court *also* assumes that buyers and sellers rely -- not just on the market price -- but on the "*integrity*" of that price. It is this aspect of the fraud-on-the-market hypothesis which most mystifies me. . . .

Even if securities had some "value" -- knowable and distinct from the market price of a stock--investors do not always share the Court's presumption that a stock's price is a "reflection of [this] value." Indeed, "many investors purchase or sell stock because they believe the price *inaccurately* reflects the corporation's worth." See Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L.Rev. 435, 455 (1984) (emphasis added). If investors really believed that stock prices reflected a stock's "value," many sellers would never sell, and many buyers never buy (given the time and cost associated with executing a stock transaction). As we recognized just a few years ago: "[I]nvestors act on inevitably incomplete or inaccurate information, [consequently] there are always winners and losers; but those who have 'lost' have not necessarily been defrauded." *Dirks v. SEC*, 463 U.S. 646, 667 n.27 (1983). Yet today. the Court allows investors to recover who can show little more than that they sold stock at a lower price than what might have been.[7]

I do not propose that the law retreat from the many protections that § 10(b) and Rule 10b-5, as interpreted in our prior cases, provide to investors. But any extension of these laws, to approach something closer to an investor insurance scheme, should come from Congress, and not from the courts.

II

Congress has not passed on the fraud-on-the-market theory the Court embraces today. That is reason enough for us to abstain from doing so. But it is even more troubling that, to the extent that any view of Congress on this question can be inferred indirectly, it is contrary to the result the majority reaches.

A

In the past, the scant legislative history of § 10(b) has led us to look at Congress' intent in adopting other portions of the Securities Act when we endeavor to discern the limits of private causes of action under Rule 10b-5. See, e.g., *Ernst & Ernst v. Hochfelder,* 425 U.S. 195, 204-06 (1976). A similar undertaking here reveals that Congress flatly rejected a proposition analogous to the fraud-on-the-market theory in adopting a civil liability provision of the [Exchange] Act.

Section 18 of the [Exchange] Act expressly provides for civil liability for certain misleading statements concerning securities. When the predecessor of this section was first

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[7] This is what the Court's rule boils down to in practical terms. For while, in theory, the Court allows for rebuttal of its "presumption of reliance"--a proviso with which I agree, in practice the Court must realize, as other courts applying the fraud-on-the-market theory have, that such rebuttal is virtually impossible in all but the most extraordinary case. See Blackie v. Barrack, 524 F.2d 891, 906 & n.22 (9th Cir.1975), cert. denied, 429 U.S. 816 (1976); In re LTV Securities Litigation, 88 F.R.D. 134, 143 n.4 (N.D.Tex.1980). Consequently, while the Court considers it significant that the fraud-on-the-market presumption it endorses is a rebuttable one, the majority's implicit rejection of the "pure causation" fraud-on-the-market theory rings hollow. In most cases, the Court's theory will operate just as the causation theory would, creating a non-rebuttable presumption of "reliance" in future 10b-5 actions.

being considered by Congress, the initial draft of the provision allowed recovery by any plaintiff "who shall have purchased or sold a security the price of which may have been affected by such [misleading] statement." See S. 2693, 73d Cong., 2d Sess., § 17(a) (1934). Thus, as initially drafted, the precursor to the express civil liability provision of the 1934 Act would have permitted suits by plaintiffs based solely on the fact that the price of the securities they bought or sold was *affected* by a misrepresentation: a theory closely akin to the Court's holding today. Yet this provision was roundly criticized in congressional hearings on the proposed Securities Act, because it failed to include a more substantial "reliance" requirement. . . .

Congress thus anticipated meaningful proof of "reliance" before civil recovery can be had under the Securities Act. The majority's adoption of the fraud-on-the-market theory effectively eviscerates the reliance rule in actions brought under Rule 10b-5, and negates congressional intent to the contrary expressed during adoption of the 1934 Act. . . .

III

Finally, the particular facts of this case make is an exceedingly poor candidate for the Court's fraud-on-the-market theory, and illustrate the illogic achieved by that theory's application in many cases. Respondents here are a class of sellers who sold Basic stock between October, 1977 and December 1978, a fourteen-month period. At the time the class period began, Basic's stock was trading at $20 a share (at the time, an all-time high); the last members of the class to sell their Basic stock got a price of just over $30 a share. It is indisputable that virtually every member of the class made money from his or her sale of Basic stock.

The oddities of applying the fraud-on-the-market theory in this case are manifest . . . . [I]t is possible that a person who heard the first corporate misstatement and *disbelieved* it -- *i.e.*, someone who purchased Basic stock thinking that petitioners' statement was false -- may still be included in the plaintiff-class on remand. How a person who undertook such a speculative stock-investing strategy -- and made $10 a share doing so (if he bought on October 22, 1977, and sold on December 15, 1978) -- can say that he was "defrauded" by virtue of his reliance on the "integrity" of the market price is beyond me.[8] And such speculators may not be uncommon, at least in this case.

Indeed, the facts of this case lead a casual observer to the almost inescapable conclusion that many of those who bought or sold Basic stock during the period in question flatly disbelieved the statements which are alleged to have been "materially misleading." Despite three statements denying that merger negotiations were underway, Basic stock hit record-high after record-high during the 14-month class period. It seems quite possible that, like Casca's knowing disbelief of Caesar's "thrice refusal" of the Crown, clever investors were skeptical of petitioners' three denials that merger talks were going on. Yet such investors, the savviest of the savvy, will be able to recover under the Court's opinion, as long as they now claim that they believed in the "integrity of the market price" when they sold their stock (between September and December, 1978). Thus, persons who bought after hearing and relying on the *falsity* of petitioner's statements may be able to prevail and recover money damages on remand.

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[8] The Court recognizes that a person who *sold* his Basic shares believing petitioners' statements to be false may not be entitled to recovery. Yet it seems just as clear to me that one who *bought* Basic stock under this same belief -- hoping to profit from the uncertainty over Basic's merger plans -- should not be permitted to recover either.

And who will pay the judgments won in such actions? I suspect that all too often the majority's rule will "lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." Cf. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir.1968) (en banc) (Friendly, J., concurring), cert. denied, 394 U.S. 976 (1969).